PO-CH/NL/0310
PART C

Part. C.

SECRET

(Circulate under cover and notify REGISTRY of movement)

Begins: 2/6/89.
Ends: 24/10/89.

PO -CH /NL/0310

PART C

Chancellor's (Lawson) Papers:

FUNDING POLICY AND ARITHMETIC: THE ALTERNATIVE TO BUYING BACK GILTS

DD's: 25 Years

D Andrews
25/10/95

PO -CH /NL/0310
PART C

mg.ee/dlcp/31.5-ch.

CONFIDENTIAL

From : D L C Peretz (MG)
Date : 2 June 1989
x 4460

1. SIR PETER MIDDLETON

2. CHANCELLOR

cc Economic Secretary
Sir T Burns
Mr Wicks
Mr Scholar
Mr A Edwards
Mr Odling-Smee
Mr Riley
Mr Gieve
Mr Grice
Miss O'Mara
Mrs Ryding
Mrs Chaplin

MONEY MARKET ASSISTANCE

I attach our paper. We have discussed this with the Bank, at a meeting chaired by Sir Peter Middleton.

2. We have already increased the size of the weekly Treasury bill tender, and this should hold the position for the time being.

3. We recommend taking action to try to encourage local authorities to run down their deposits with banks and repay PWLB debt, on the lines proposed in paragraph 7 of the paper - though we will need to move carefully to ensure the measures have no unwelcome side effects.

4. Beyond that, if further action is needed the choice is broadly :-

i) stick to the present funding rule, and take deposits ("special deposits" or otherwise) from the banks if necessary.

ii) switch to a maturity-based funding rule which has attractions on merits, but is likely to do little to help the money market position. Again it could become necessary to take deposits from the banks.

10

iii) depart from the full fund policy (any definition) if necessary to maintain a desired level of money market assistance without putting undue strain on the Treasury bill issue.

5. In the normal course of events there would be no need to take decisions on this now. You might have wanted to take an opportunity to discuss the issues with us and the Bank. And you should note the further (confidential) contingency work (para 47(ii)) of the paper) we are proposing to carry out on schemes for taking deposits from banks and building societies.

6. However today's FT story by Simon Holberton, and the market reaction to it, have already driven us to say we have no plans to change our funding policy (and under the pressure of questioning about whether there was a review under way IDT were forced to say - which is true - that you had not asked officials to review it). In the circumstances you may decide you want to say something on the issue when you speak in the House on Wednesday - in which case the funding policy aspect is more urgent.

DLCP

D L C PERETZ

cc Mr George) Bank of England
Mr Coleby)
Mr Plenderleith)
Mr W Allen)

CONFIDENTIAL

MONEY MARKET ASSISTANCE : WIDER ISSUES

We have now as agreed stepped up the Treasury bill tender, issued 6 months as well as three month Treasury bills and announced that the Bank will in future normally only buy shorter maturity bills. This should for the time being enable us to maintain day to day money market shortages and thus retain control of interest rates.

2. We have also been looking at some wider issues raised by the change in the money market position, and whether it will be necessary to consider any further supplementary measures. We have focused on three aspects :-

i) **Local authority financing.** The present "problem" is in large part the result of the changed liquidity position of local authorities which, in turn, may to some extent be the result of the delayed success of a measure taken before the end of overfunding in 1985 to try to reduce the size of the then rapidly rising bill mountain. We made changes in the terms of PWLB finance designed to encourage local authorities to borrow more from the PWLB and less from the banks and elsewhere. Such a shift reduces the need for money market assistance by the Bank. Could further changes now be made that would be sensible in their own right but which would reverse the process?

ii) **Funding policy.** The funding rule we now follow is intended to ensure that the public sector as a whole does not increase (or reduce) its net reliance on borrowing from banks and building societies, and from the note and coin issue. It is based on the M4 counterparts analysis. We have in the past considered other possible funding rules. How would they have affected the position, and what difference would the adoption of a different rule make in future?

iii) Other action the Bank could take to remove the money market surplus, to supplement the increase in the Treasury bill issue. The obvious possibility is to take deposits, voluntarily or otherwise, from the banks and building societies.

HOW DID WE GET WHERE WE ARE?

3. How and why has the present situation has arisen? The present funding rule if followed ensures no change, year to year, in the money total of the public sector's liabilities that take the form of notes and coin or net borrowing from banks and building societies. That is it ensures that the arithmetic sum of the public sector counterparts to M4 is zero. In fact, as the following table shows, we have overfunded on this measure - ie reduced the public sector's net liabilities to banks/building societies or in the form of notes and coin - over the period since the peak of money market assistance (at £17 billion) in March 1985.

TABLE 1

Change in the public sector's net liabilities to banks/building societies or as notes and coin : March 1985 - March 1989

	£ billion
Rise in note and coin circulation	+ 3.1
Bank and building society net sales of gilts and other public sector debt	- 5.5
Increase in LA deposits/reduction in LA bank borrowing	-11.1
Increase in Public Corporation deposits/ reduction in PC bank borrowing	- 4.9
Reduction in B of E holdings of bills	+12.9
Other	- 2.2
Total change (= M4 overfunding)	- 7.7

4. Measured in this way, therefore, over the whole period public sector transactions have tended slightly to depress short rates in relation to long rates. The reasons for this are first that over the period March 1985 - March 1988 we were following an M3 funding rule - and this led to significant over funding as measured against M4; and second, the £2½ billion overfund in 1988/89.

5. The table shows, however, the very substantial switch in the position of the different parts of the public sector with the banks and building societies over the period. The largest factors are :-

a) A £7.0 billion increase in LA bank deposits, and £4.1 billion reduction in LA bank loans (giving the £11.1 billion total change in the LA position), as local authorities have borrowed more from the PWLB, and placed part of the proceeds of asset sales with banks and building societies, rather than repay PWLB debt.

b) £5.5 billion sales of gilts etc by banks and building societies (£4.7 billion of which took place in 1988-89).

c) Offset by a £12.9 billion fall in the Bank of England's bill holdings, and a £3.1 billion rise in the note issue. (In 1985 we thought the rise in the note issue would over time be the major factor, leading - under the full fund rule - to a steady rise in the bill mountain).

POSSIBLE ACTION ON LOCAL AUTHORITY FINANCIAL TRANSACTIONS

6. The impact of the changes in LA deposits and borrowing is, of course, in the direction we originally intended when authorities were encouraged to turn to the PWLB. The difficulty is that it has gone so far in a period when the previous rapid growth in the bill mountain was halted by the end of overfunding. Not only has it led to the fall in money market assistance but it has encouraged some local authorities to become, in effect, financial

intermediaries, increasing their financial assets rather than using capital receipts to reduce their financial liabilities. This is unhealthy; and it may also be unhealthy for local authorities to have become so dependent on borrowing from central Government, and protected from the discipline which would result from having to raise more of their own debt in the market.

7. We therefore think that there is merit in pursuing three courses of action already being considered within the Treasury :

- We (FIM) are considering whether to increase some of the rates charged by the PWLB, and/or to reintroduce more restrictive loan quotas. Either of these options would initially increase LA costs, but there should be an offset if greater exposure to market disciplines led to efficiency improvements and lower capital spending.

- We (LG) are pressing DOE to take adequate powers in the current Local Government Bill to limit LAs freedom to invest surpluses rather than applying them to repay debt.

- Following on from this, we (FIM) have been considering removing the financial penalty that operates to discourage local authorities from repaying early PWLB loans which have rates below current rates. Up until now we have retained this penalty to restrict the attraction to LAs of playing the market against PWLB by continually restructuring their debt. But we think it would now make sense to relax this rule in some way, to offer LAs opportunities to repay early without penalty.

8. Action under the first and second of these headings would take some time to put in place. The local authorities would need to be given ample warning of changes in PWLB facilities, and the new LA capital finance regime will not take effect before 1 April 1990.

9. Action under the third heading, however, can be taken fairly quickly, and we recommend that it should. This may not have much effect; LAs may well want to continue to make a temporary turn by hanging on to lower rate long term loans and holding surplus cash on short term deposit. We just do not know in advance of trying it. But the direction at least is clear and would now be helpful for money market management : it would tend to take money out of the banking system, increasing the shortages against which the Bank of England can operate.

FUNDING RULE

10. Next, we have looked at the operation of the funding rule. Had we sold more gilts over the last four years (or, recently, bought less), the level of money market assistance (Bank of England bill holdings) would now be greater. The Bank would have had to place the extra funds borrowed by buying extra commercial bills.

11. It can be argued that there would have been an extra indirect effect on top of this : that had we sold more gilts, long term interest rates would have been higher in relation to short rates, and this might have encouraged LAs to deploy their surplus funds to reducing long term debt rather than running up deposits. It might also have discouraged banks/building societies from selling gilts. It seems unlikely, however, that the effect on the yield curve would have been sufficient to make a significant impact on LAs' behaviour - even if the overfunding had been very substantial. We had a sharply downward sloping yield curve in somewhat similar conditions in early 1985, before the end of overfunding. And given that the total stock of gilts outstanding has been reduced, bank/building society sales have not been exceptionally high, at least given the regulatory changes that have also encouraged building societies - and, to a lesser extent, banks - to sell gilts.

12. Nevertheless, we should consider the case for a relaxation or change in the funding rule, since over time that could have a substantial direct effect on the money market position, even if

there is no indirect effect. We have considered several options and these are discussed in the following paragraphs. Paragraphs 31-33 deal with presentational issues.

Return to Discretion

13. One option would be a **return to discretion**, ie, either a move to unconstrained overfunding (or underfunding), or a return to using funding policy to try to hit some target for M4. In the second case we would once again be trying to use funding policy to try to compensate for private sector behaviour, with potentially counter-productive effects. In the first case the only constraint would be that implied by the MO target, which would limit the extent of borrowing by creation of base money. Apart from that there would be no clear discipline over the form or liquidity of Government borrowing. We do not recommend this.

14. First, we remain of the view that in principle it is useful to have a discipline for the Government's financing policy, to limit its impact on broad money or liquidity as well as on base money. Liquidity is not a precise concept. But it seems clear that national savings products where the money is locked up (or encashable early only with a penalty) or gilts, where there is a price risk are less liquid - less useable as money - than bank deposits or Treasury bills.

15. Second, in current circumstances we do not believe that it would be helpful to take action that would flatten the yield curve in any significant way by taking money, net, out of the long end of the market - where money is more likely to be borrowed by companies, for investment - and lending it back at the short end - where it is more likely to be borrowed for consumption. (The second point, however, is less strong if we believe the impact on the yield curve would be modest).

Funding the CGBR rather than PSBR

16. Under the present rule, the Government funds the PSBR (or unfunds the PSDR) sectorally, that is by sales of debt outside the

bank and building society sectors. A further option would be to replace this PSBR sectoral rule by a CGBR sectoral rule under which the Government funds the CGBR only. An argument can be made for this. The present rule requires central government to compensate for any monetary financing undertaken by local authorities or public corporations. A CGBR-sectoral rule would in effect treat financing by local authorities and public corporations like borrowing by the private sector. If as a consequence of such monetary financing, liquidity came to exceed that which the economy would willingly hold, we would raise short-term interest rates to tighten monetary conditions appropriately. But we would take no more direct action than that.

17. Table 2 demonstrates what would have happened had we followed a CGBR-sectoral rule (and a variety of other possible rules discussed below) over the last 4 years. It would have made a very large difference to gilt sales : we would have sold, net, about £10½ billion more gilts than we did. The level of money market assistance would have been higher than it is, by a corresponding amount. And the public sector counterparts to M4 would have contracted by £10½ billion more. The reason for the differences is clear. Local authorities were replacing bank borrowing with borrowing from the central Government, and increasing their deposits with banks. Under a PSBR sectoral rule that counts as a reduction in the public sector's contribution to liquidity, reducing the need to sell gilts. With a CGBR sectoral rule the extra LA borrowing from central Government increases the CGBR and adds to the requirement to sell gilts.

TABLE 2

Money Market Assistance Under Alternative Funding Rules : Change from March 1985 to March 1989 (£ billion)

		Change in MMA	Effect on M4 public sector counterparts**
PSBR - Sectoral Rule : (Current Rule)	Actual	-12.9	- 7.7
	Full Fund	-20.6	0
CGBR - Sectoral Rule*		- 3.5	-17.1
PSBR - Maturity Based Rule*		+ 2.5	-23.1
CGBR - Maturity Based Rule*		+17.0	-37.6

* Assuming a full fund achieved on this basis.

** This would not however have been the effect on M4 : there would have been offsets in the other counterparts.

18. The future however may not be like the past. Almost all local authority borrowing is now from the PWLB. There could be some further shift away from market borrowing and into the PWLB in the coming months as a result of market reactions to the LA swaps cases. But over a longer period we would expect a gradual run down local authority net deposits with the banks and in the £40 bn of PWLB loans outstanding, as a result of the measures proposed in paragraph 9 above to discourage local authority borrowing from the PWLB, to encourage early repayment, and to discourage local authorities running up deposits with banks and building societies. In that case the switch to a CGBR rule would have come at just the moment when the present PSBR rule began to have the more expansionary effect on money market assistance and more contractionary effect on the M4 counterparts. This is discussed further in Annex 1.

19. If we wanted to make the switch this would suggest leaving it for some years. But there are in any case arguments of principle

against moving away from a PSBR-based rule. Notwithstanding the introduction of the new planning total, the Government is certainly not washing its hands of local authority borrowing, spending or taxation. On this argument, the Government should also seek to contain or offset the monetary implications of local authority financing behaviour. (It was on the basis of much the same argument that we have decided to base our debt management strategy on the financial assets and liabilities of the public sector as a whole, rather than the central government alone. If we were concerned only with the latter we should probably now be considering issuing substantial amounts of long gilts, to match long term PWLB loans to LAs).

A maturity based PSBR funding rule

20. A third option is the one we considered a couple of years ago : to adopt **a maturity based funding rule**. There are good arguments for this, as we then concluded. Moreover the practical obstacles, that were then substantial, have now largely evaporated.

21. The present rule requires us to distinguish between gilts sold to (or by) banks and building societies, and to (or by) other sectors. It is based on the so often misleading counterparts analysis. Why, one might ask, does it affect anything - and therefore why should it affect Government funding - if a bank chooses to replace a gilt in its portfolio with a similar sterling corporate bond? This is the point made by Adam Bennett in his recent Shearson Lehman Hutton piece. Professor Tew also made a similar point to the TCSC. He suggested ceasing to count gilts sales by banks and building societies as funding (and by implication, therefore, counting gilt sales to banks and building societies as funding). But this by itself would leave no constraint at all on the form of Government financing - other than the limit implied by the MO target on the amount that can take the form of base money creation.

22. A maturity based rule says that the prime consideration should be not the sector buying (or selling) government debt, but

the maturity of the instruments sold, regardless of who buys them - taking term to maturity as a proxy for illiquidity. We do of course already take the "quality" of funding into account : a maturity based rule would turn this into a firm constraint. The rule might be to adjust borrowing/debt repayment so as to keep constant the money total of public sector net liquid liabilities, defined as liabilities at less than 2 year maturity*.

23. The increased Treasury bill issue strengthens the case for such a change. Possibly quite a significant proportion of the extra Treasury bills now being issued will be held outside the bank/building society sector, for example by overseas central banks. Under the present funding rule this will count as funding, and require us to buy in extra gilts with an overall deterioration in the quality of our funding. (This may be the point Professor Tew was making in his letter to the FT on 15 May).

24. Again, it can be seen from Table 2 that following such a maturity-based rule in the past would have made a massive difference, cumulatively, to net gilt sales over the last 4 years : we would have needed to sell, net, around £15 billion extra gilts, and the level of money market assistance now would have been correspondingly higher. Indeed it would be at or marginally higher than its 1985 peak, in cash terms.

25. In this case the difference is not caused by local authority behaviour (we are discussing a PSBR maturity-based rule), but for three other reasons :

i) sales of gilts by banks and building societies (mainly last year) would not have led us to reduce new gilt sales;

---

* Floating rate debt, however, would have to be treated as liquid whatever its nominal maturity, since there is no price risk.

ii) the net amounts taken, over the period as a whole, into the more liquid national savings products (not offset over the period by the recent reduction in GER money, and in CTDs).

iii) because of an increase over the 4 years in the quantity of gilts outstanding in the 0-2 year maturity range, following quirk of the maturity profile.

26. Again, however, we need to consider what difference a switch to such a rule would make in future, as well as in the past. The answer depends crucially first on whether banks and building societies continue, as last year, to shed their holdings of gilts; and second on what happens to the more liquid national savings (and other) products. The first factor seems to vary sharply from year to year. It seems likely that, for example, Abbey National will sell a substantial quantity of gilts once it becomes a bank, but this could be offset by gilt purchases by other banks. As to the second factor, the more successful we are in pursuing our policy of running down the more liquid national savings products, such as money held on general extension rate terms, and other liquid liabilities such as CTDs, the more likely a maturity-based rule would be to work in the opposite direction in future than it has hitherto. On the other hand, some of the largest liquid products - the Investment Account or Income Bonds, for example - are available because of a particular service they provide rather than because of good quality funding. Unless we offer deliberately unattractive rates, their trend would probably be upwards than the reverse.

<u>**A maturity based CGBR rule**</u>

27. A fourth option would be to combine the previous two, that is **a maturity-based CGBR rule.** As Table 2 shows, this would have had an even more dramatic effect if applied in the past, combining the effects set out in the previous paragraphs. We would have had to sell around £30 billion more gilts than we did over the period, and rather than declining, the bill mountain would now be twice its actual peak in 1985 - a change that would have faced us with very considerable money market management problems, probably

requiring us to develop a scheme for the Bank of England placing deposits with banks.

Targetting money market assistance

28. A final option would be to adjust funding policy **to control the level of the Bank's money market assistance.** Although there are limits to how much fine tuning is possible, we could, for example, try to sell gilts when the Bank's holding of commercial bills looked on the low side, and buy them back when the bill mountain reached an uncomfortable level. Targetting money market assistance would not by itself be a funding rule at all : at least it would not limit the public sector's contribution to net liquidity. For example, it gives no guidance on whether to raise the level of the Bank's bill holdings, if that is desired, by selling gilts, or by increasing the Treasury bill issue, or by borrowing from the banking system.

29. We might however be able simply to run this as a kind of override to funding policy. We could, for example, stick normally with a full fund policy, as at present, but be prepared to depart from it in two circumstances :

i) if the total of MMA were to get too low - or rather if the level of Treasury bill issue needed to keep it at an acceptable level became too high - then we would overfund.

ii) if (as in 1985) the level of MMA were to get too high, then we would underfund.

Future projections under different scenarios

30. We have considered what the level of money market assistance might turn out to be in one and three years' time, under the different funding rules discussed above. The results are set out in Annex 1 - and summarised in Table 5 of Annex 1. There are great uncertainties. But _if_ the measures set out in paragraph 7 have the effect of turning the LA position round, then in due

course the bill mountain will reappear again with the present funding rule. With a PSBR based maturity rule the level of money market assistance might remain broadly as at present.

Funding policy changes : summary and presentational issues

31. The critical point seems to be this. The purpose of a funding rule is to keep the liquidity impact of public transactions broadly neutral. Variant rules are possible depending upon how exactly liquidity is defined and whether we are concerned with liquidity generated by central government or by the public sector as a whole. The possibilities discussed above by no means represent a complete list : for example one could construct a rule based on a desired liquidity distribution for the stock of government debt, rather than annual flows. In each case, there will be implications for the level of money market assistance. But no funding rule (that is no rule designed to limit the public sector's contribution to liquidity) can be guaranteed to ensure that it remains constant at a chosen level because money market assistance is only one element - in fact a negative component - of the government's contribution to net liquidity.

32. Even if we decided to stick to the present rule for the time being, it might still be worth considering at least one rather modest change in the direction of a maturity-based rule. The increased Treasury bill tender, and the likelihood that an increasing volume of Treasury bills will be held outside the banks and building societies, suggests making the small step in the direction of a maturity-based rule of ceasing to count Treasury bill sales as funding, irrespective of the sector they are sold to. In effect this would mean treating Treasury bills like notes and coin - where also we do not treat increases in the amount on issue as funding, irrespective of who buys them.

33. Any change in the funding rule would require careful presentation. Given what has been said in the past, a return to discretionary overfunding would be difficult, even if we thought it justified on merits (which we do not). And there would be a general difficulty with any change that lead to the PSDR being

applied to running up assets (except perhaps foreign exchange assets, where the reasons are better understood) rather than repaying debt.

34. A switch to a maturity based rule would be a substantial change : perhaps to be announced in the Mansion House Speech (though it could be applied retrospectively to the whole financial year). The more modest change suggested in paragraph 32 could perhaps be announced immediately, as a response to a new development. We could simply say that we would not use the proceeds of the increased Treasury bill issue to repay gilts, even where the bills were sold outside the bank/building society sector. This would however undoubtedly be seen, correctly, as a move in the direction of a maturity based rule : and we might then be pressed to explain why we were not going the whole way.

35. A move to adjusting gilt sales with an eye to the level of money market assistance, as in paragraph 29, might initially not need announcing at all. We would simply aim off the full fund policy where necessary. At present this would lead us to slow down, maybe stop, market purchases of gilts as and when we felt the Treasury bill tender was becoming too large. In due course, however - assuming the operation had not been reversed within the year - we would need to explain what it was that had led us to overfund.

OTHER ACTION TO MOP UP MONEY MARKET SURPLUSES

36. To summarise the analysis so far, it seems likely that the action discussed in paragraphs 6-9 above in respect of local authority financing will, increasingly with time, encourage local authorities to run down their net deposits (probably reducing their borrowing from the PWLB) thereby reducing money market surpluses. But there remains the possibility that neither that action, nor any desirable change to the funding rule discussed above, will prevent substantial money market surpluses arising in the course of the next year or so. As Table 5 in the Annex illustrates, the range of possible outcomes is great, but a central forecast, perhaps, is that, even after allowing for some

early effect of local authority measures, we might need to have increased the value of Treasury bills on issue from the £3 billion outstanding in March this year to a peak of perhaps £15 billion or more in the course of 1990-91, to retain day by day money market shortages throughout the next financial year.

37. There are advantages in reviving the Treasury bill market in this way. It will add a new and important element to the sterling markets. And arguably it is better for the authorities to operate by dealing in our own paper - as indeed was the normal practice before the 1980s - rather than private sector paper.

38. There are however circumstances in which it could prove difficult to rely exclusively on an enlarged Treasury bill issue :

- the scale of individual tenders needed to relieve the surpluses could become so large that it exceeds the market's capacity to absorb them. At the moment, the scale of Treasury bill issue required looks small by historical standards. But we cannot be sure that this will remain true.

- more likely, we could run into difficulties along the lines encountered a few weeks ago, when there was strong upward pressure on interest rates which we wished to resist, and in order to sell bills we would have had to accept offers which implied that the authorities would countenance higher interest rates. On that occasion we declined all offers, partly as a signal that we did not want to see higher rates. This would become more difficult if the increased Treasury bill tender were the only way of retaining control in the money markets.

39. This has led us to consider what other techniques might be used to remove the surplus, to supplement the increased Treasury bill issue. The obvious alternative is some form of facility for taking deposits in the public sector.

A deposit facility for local authorities

40. We have considered briefly the possibility of opening a **public sector deposit facility for local authorities.** This would be identical, in its money market effects, to encouraging authorities to use their bank deposits to repay PWLB debt. But there would be major administrative difficulties in running a deposit facility for 600 local authorities, and further difficulties in offering terms sufficiently attractive to bid local authority deposits away from banks. Moreover, such a move would appear to cut across the proposals above to reduce the level of local authority deposits, and expose local authorities more to market disciplines.

Voluntary deposits from banks, or Bank of England CDs

41. A second option would be for the Bank of England to open up a facility for taking **voluntary deposits**, from banks - or a facility for selling Bank of England CDs. In most forms this proposal is open to the objection that it is simply a different form of Treasury bill. If anything it would be likely to secure slightly worse terms for the authorities than Treasury bills; and in the very circumstances when Treasury bills could not be sold, there would also be similar problems, for example, selling Bank of England CDs.

42. There is another option that might be worth considering further : a deposit facility with the Bank of England in which deposits were taken at a term of notice, rather than at a fixed term - say at 3 months' notice. So long as depositing banks only exercised their notice period infrequently, this could provide a relatively stable "base" of deposits taken from the market, with a corresponding reduction in the size of required Treasury bill issue. However, as with the idea discussed in paragraph 40, there could be problems in offering sufficiently good terms to attract such deposits.

Mandatory deposits

43. Finally, in principle, we have the possibility of calling **Special Deposits** : mandatory deposits taken from the banking system. Although these have not been called since 1979, the scheme has not been formally ended. Indeed, the published weekly Bank of England Return still has an entry for Special Deposits in the Banking Department, though always, of course, zero. The term is unfortunate, reminiscent as it is of the Supplementary Special Deposit Scheme - the Corset - which was a form of credit control, though actually Special Deposits were first introduced some 15 years in advance of the Corset. In fact, the scheme is more or less identical to the (remunerated) required reserved ratio schemes operated, for example, in Germany and the US - and indeed operated in those countries for precisely the same reason : to maintain control over short-term interest rates.

44. There are, however, a number of other difficulties apart from the name :-

i) for obvious reasons, a call for mandatory deposits could not be used when we had to pull the Treasury bill tender to resist upward movement in rates. The trick would be to have taken out enough of the surplus well in advance, by the use of such deposits, so as to be less reliant on issuing Treasury bills every week to maintain control of interest rates.

ii) the current scheme does not apply to building societies. Given that it has no statutory basis, we could expect considerable complaints from banks were we now to seek to apply it to them and not to building societies. Our judgement is that we could introduce it for banks, so long as we were prepared to say at the same time we were entering into discussions with the building societies with a view to extending it to them.

iii) we also need to consider further whether calling such deposits would in any way cut across prudential and liquidity requirements imposed by the supervisors.

45. Given the range of other possible action discussed above, we are some way off needing to consider a call for Special Deposits. But we suggest that nevertheless, on a contingency basis it would now be sensible to :

- raise the matter with the Building Societies Commission, on a confidential basis, to see if they have any comments from a prudential point of view.

- consider further how such a move could be presented, and in particular the possibility of a different name.

<u>**SUMMARY**</u>

46. Money market assistance has declined over the last 4 years for two mains reasons : large net sales of gilts by banks and building societies, and an even larger shift in the position of local authorities with banks and building societies. The fall has taken place despite substantial overfunding over the period as measured on the present M4 funding rule.

47. We have considered a number of supplementary steps that might be taken to maintain daily money market shortages, and hence our control over short-term interest rates, beyond the increase in the Treasury bill tender already announced.

i) There are other grounds for wishing to encourage local authorities to borrow more from the market, and to run down their deposits by using them as a substitute for new borrowing, or to finance the early repayment of outstanding debt. We propose an early move to remove the present financial penalty on early repayment of some PWLB loans (paragraphs 6-9).

ii) While different possible funding rules would have made a significant difference in the past, we cannot in most cases be sure what the relative effects would be in the future. There remain arguments on merits for considering a switch to a maturity-based funding rule.

Short of such a radical change, a more modest immediate change would be to remove Treasury bills from the definition of funding, regardless of the sector they are sold to. The only option that could be counted on to help with the money market position is to be prepared to depart from the full fund policy, if necessary. (Paragraphs 10-35).

iii) Measures under (i) could help reduce money market surpluses in the medium-term. Some possible measures under (ii) could be counted on to have a more immediate effect, but others could not. Meanwhile, there are circumstances in which it would be awkward to be reliant only on increased Treasury bill tenders. We therefore suggest further contingency work on two possible options :-

- a scheme for the Bank to take deposits from banks and building societies. Could a version of such a scheme be devised that would form a useful complement to Treasury bills? (para 42).

- the Special Deposit scheme, for the Bank to take mandatory deposits. We suggest some further work, on a contingency basis, (a) to discuss in confidence with the Building Societies Commission whether there would be any prudential consequences of extending the scheme to building societies; and (b) on presentation, and in particular whether a less emotive name can be devised. (Paras 43-45).

ANNEX 1

Future Money Market Assistance under different funding rules

This annex discusses what the level of money market assistance might turn out to be under the various possible funding rules discussed in the main paper. In each case, the discussion notes the most important factors which bear on each and their possible impact, as well as giving a central projection.

2. CGBR Sectoral Rule. Under this rule, the Government would fund only the CGBR, and not the rest of the PSBR, though any local authority or public corporation borrowing from central government would be funded since that on-lending would raise the CGBR. In this regime, only two factors could change the level of money market assistance

(a) changes in notes and coin in circulation with the public. An increase would raise assistance by an equal amount. Assuming that M0 (99 per cent of which is accounted for by notes and coin) grows in line with the MTFS projections, the notes and coin circulation will increase by around £½ billion over the next year and by around £1¼ billion over the next three years;

(b) banks and building societies' net purchases of government debt would also raise assistance; net sales would reduce it. Over the last few years, building societies have been selling gilts under pressure from changes in the regulatory regime. That process has not quite ended but seems to be near to it. Banks have been sizeable traders in gilts both ways but with no clear trend. Our central projections, used for funding arithmetic purposes, assume net sales by the two sets of institutions of £½ billion a year in each of the next three years. But their total holdings are around £13 billion so that net sales could be much greater.

Equally, should the banks in particular come to see gilts as a good investment, there could be sizeable net purchases - perhaps up to £10 billion or so over the next three years.

3. Bringing together these effects, money market assistance might change under this rule as follows:

TABLE 1

£ bn.

Factor	Next 1 Year Central Estimate	Next 1 Year Approximate Range	Next 3 Years Central Estimate	Next 3 Years Approximate Range
(i) Note circulation	+½	¼ to ¾	1¼	1 to 1½
(ii) Bank/building society transactions in cg debt	-½	-5 to +5	-1½	-10 to +10
Total effect	-	-4¾ to +5¾	-¼	-9 to +11½

4. Thus the central expectation would be of little change in the level of assistance under this rule over the next four years but with a large range of uncertainty about that projection.

5. <u>A PSBR Sectoral Rule (the Current Rule)</u>. Money market assistance under this rule is more difficult to project than in the previous case. Apart from changes in the note and coin circulation and banks and building societies' net purchases of central government debt, money market assistance can also be altered as a consequence of changes in the net debt position of the rest of the public sector against these institutions. In particular, allowance needs to be made for the effects of local authorities borrowing from the PWLB and/or depositing the proceeds of assets sales with the banking/building society sector rather than repaying PWLB debt - either to increase their deposits or reduce their bank borrowing. This would reduce money market assistance: alternatively, reduction of local authorities' net bank or building society deposits, for example to repay PWLB lending would increase required assistance.

6. The current financial forecast assumes that local authorities will increase their net bank/building society deposits by about £5¾ billion in 1989-90 on the basis of increased PWLB borrowing of about £1½ billion. Over the three years 1989-90 to 1991-92, the total increase in bank/building society deposits might be about £11½ billion supported by £4½ billion of extra borrowing from the PWLB. On this scenario, there would be a fall in money market assistance of £5¾ billion in 1989-90, mounting to a fall of £11½ billion over the three years together, on account of this factor alone. On the other hand, if as a result of measures to discourage local authorities from borrowing from the PWLB, there is a reduction in PWLB lending outstanding, then the fall in money market assistance would be attenuated, if not reversed, pari passu.

TABLE 2

£ bn.

Factor	Next 1 Year		Next 3 Years	
	Central Estimate	Approximate Range	Central Estimate	Approximate Range
(i) Note circulation	+½	¼ to ¾	1¼	1 to 1½
(ii) Bank/building transactions in cg debt	-½	-5 to +5	-1½	-10 to +10
(iii) Effect of changes in local authority net bank deposits:				
a) Financial Forecast Case	-5¾	-9 to -2	-11¾	-18 to -6
b) PWLB lending restricted*	- ¼	-3 to +3	+ 7¾	-2 to +14
Total Effect: a)	-5¾	-13¾ to+3¾	-12¼	-27 to +5½
Total Effect: b)	- ¼	- 7¾ to+8¾	+7½	- 7 to +25½

* Assuming net repayments to PWLB of £4 billion in 1989-90 and £15 billion over the three years 1989-90 to 1991-92 (out of £43 billion currently outstanding).

7. Overall, if no measures were taken to curtail local authority access to the PWLB, the expectation would be that money market assistance would again fall heavily in 1989-90, on this rule, and for the decline to continue for at least the next two years. On the other hand, if access to the PWLB were severely restricted and substantial repayments induced, the decline in 1989-90 might be significantly reduced and there would be the prospect of a rise in assistance in later years. But the margins of error on these projections are in all cases very large.

8. A PSBR Sectoral Rule with a Money Market Assistance Override. This would be a hybrid based on the current rule but with the proviso that should it lead to unacceptably high or low levels of money market assistance then net gilt sales would be adjusted to compensate. For purposes of illustration, one might suppose that the aim was to ensure that Issue Department holdings of commercial bills should not exceed £6 billion (the upper limit for assistance). To characterise the lower limit, the supposition might be that Treasury Bill issues required to produce the shortages against which the authorities set interest rates should not exceed £6 billion.

9. What is of interest in this case is the extent to which the override would be required to operate. This can be gauged from Table 2 which shows the changes in net money market assistance on the current rule (ie money market assistance less Treasury Bills outstanding required to produce that gross assistance). At the end of 1988-89, net assistance stood at around £¾ billion (gross assistance of £4 billion less Treasury Bills outstanding of £3¼ billion). Applying the changes from Table 2, the prospective level of net assistance can be calculated as in Table 2A.

TABLE 2A

Levels of Net Assistance

£ bn.

	Next 1 Year		Next 3 Years	
	Central Estimate	Approximate Range	Central Estimate	Approximate Range
Change (from Table 2)				
Case (a)	- 5¾	-13¾ to +3¾	-12¼	-27 to +5½
Case (b)	- ¼	- 7¾ to +8¾	+ 7½	- 7 to +25½
Implied Levels				
Case (a)	- 5	-13 to +4½	-11½	-26¼ to +6¼
Case (b)	½	- 7 to +9¾	+ 8¼	- 6¾ to +26¼
Required Over (-)/ Under (+) Funding*				
Case (a)	-	- 7 to 0	- 5½	-20¼ to ¼
Case (b)	-	- 1 to +3¾	+ 2¼	- ¾ to 20¼

* Defined by reference to present rule. Amount required to keep net assistance in the assumed permitted range of ± £6 billion.

10. The Table suggests that on our central estimates for the next year, the override would not be required and funding would be the same as under the existing rule. This is so regardless of the behaviour of the local authorities. But the margins of uncertainty are considerable. Over the longer-term, the chances of funding deviating from that indicated by the present rule are much greater. If local authorities continue to accumulate liquid assets, gilt sales might be much heavier than under the present rule - by up to £6-7 billion a year on average. On the other hand, if local authorities were induced to repay debt to the PWLB, buying back of gilts might then need to be greater than under the present rule - again by as much as £6-7 billion a year.

11. A CGBR Maturity Based Rule. Under maturity related funding rules, quite different factors would bear on the level of money market assistance from those which would apply when funding is defined by reference to sector, as with the current rule. The effect of a central government maturity-based funding rule is to ensure that the net liquid liabilities of central government - those say with a maturity of less than two years - remain constant. Money market assistance is a subset of central government liquid assets. Accordingly, a maturity-based funding rule implies that money market assistance has to rise (fall) to match a rise (fall) in central government liquid gross liabilities or a fall (rise) in its liquid assets (mainly bank deposits) other than those counted as money market assistance. These are the only changes which are relevant to money market assistance under this rule.

12. In practice, central government deposits with commercial banks are limited to working balances. Changes from year to year are unlikely to be significant in relation to money market assistance. So it is possible to concentrate on the prospective changes in central government liquid liabilities, the main categories of which are listed here.

TABLE 3

£ billion

Liability	Amount Outstanding March 1989	Expected change 1989-90	Expected change 1989-90 to 1991-92
Notes and Coin	17.0	+ ½	+ 1¼
National Savings :			
Savings Certificates*	11.7	- 1	- 4
Premium Bonds	2.3	-	-
Income Bonds	7.8	+ ¾	+1½
Yearly Plan	0.2	-	-
Ordinary Account	1.6	-	-
Investment Account	7.7	+ ¾	+1½
Deposit Bonds	0.9	- ¼	- ½
Gilts*	18.9	- 3	- 6
Tax instruments	2.0	- ¼	- ½
Funds lodged in courts	0.6	-	-
Treasury Bills	2.9		
Borrowing from Banks	0.6	-	-
Total change (= change in money market assistance)	-	-2½	-6¾

* with less than 2 years to maturity.

13. These figures lead to the expectations that assistance would fall under this rule by an appreciable amount over the next few years. On the whole, the margins of error surrounding this prediction are probably narrower than in the case of the sectoral rules - perhaps of the order of + £5 billion over the three years. The main changes are that there might be a greater shakeout of liquid National Savings products - say Savings Certificates on GER terms - than the above projections allow. In that case, the fall in assistance would be the greater to the same extent. Alternatively, if Income Bonds or the Investment Account were to return to favour with savers - for example if the rates were made more competitive - then the fall in assistance would not be so great.

14. A PSBR maturity based rule. Projecting the stock of assistance is more complicated in this case than with a CGBR maturity rule. Such a rule ensures that the net liquid liabilities of the public sector as a whole remain constant. Since money market assistance is a central government liquid asset, it may therefore need to change either because liquid liabilities of central government alter or because liquid liabilities of the rest of the public sector change or because other liquid assets held by the public sector change. Furthermore, whilst central government liquid asset holdings move only narrowly, changes in local authority bank or building society deposits can be substantial.

15. The following table shows public sector liquid assets and liabilities and the expected changes over the next few years, on the basis of the current financial forecast.

TABLE 4

£ billion

	Amount Outstanding March 1989	Expected change 1989-90	Expected change 1989-90 to 1991-92
Assets			
Bank/building society deposits	11.5	+ 5½	+10½
Liabilities			
Notes and Coin	16.3	+ ½	+ 1¼
National Savings*	32.2	+ ¼	- 1½
Gilts*	18.8	- 3	- 6
Tax Instruments	1.9	- ¼	- ½
Funds lodged in courts	0.6	-	-
Treasury Bills	2.8	-	-
Public corporation bills	0.4	-	-
Local authority longer-term debt*	0.4	-	- ¼
Local authority temporary debt	1.9	- ¼	- ¾
Bank borrowing	2.1	- ½	- 1
Total change in liabilities		- 3¼	- 8¼

* With less than 2 years to maturity.

The expected fall in money market assistance on this rule is given by the fall in liquid liabilities plus the increase in liquid assets (other than those which assistance itself represents). So assistance would be expected to fall by around £9 billion in 1989-90 and by around £19 billion over the three years together. These projections assume that local authorities continue to borrow freely from PWLB. If their access were restricted so that they repaid £4 billion of PWLB lending in 1989-90 and £15 billion over the three years, then the decline in money market assistance would be limited to £3½ billion in 1989-90 and there would be no decline at all over the three years taken together.

16. It is possible to bring together the above projections and compare the expected effects of the various rules on the level of assistance. But this is only one side of the coin. It is also important to take into account the expected effect that each would have on liquidity in the economy; what the contribution of the public sector would be in each case. Unlike Table 2 in the main text, Table 5 below shows the public sector contribution to liquidity not in the form of the M4 counterparts analysis - where the PSBR sectoral rule would have a neutral impact but in terms of the rise/fall in net public sector liquid liabilities (defined as 2 year maturity or less).

17. The results can be summarised as follows. For each rule, two cases are distinguished, to illustrate the effect of different local authority behaviour :

a) is in line with the current financial forecast with local authorities borrowing £1½ billion from the PWLB in each of the next three years;

b) assume that PWLB lending has been rendered less accessible or less attractive so that local authorities repay £4 billion in 1989-90 and a total of £15 billion over the three years to 1991-92.

As a benchmark, the effects of a constant assistance rule are also shown.

TABLE 5

£ billion

Funding Rule		Effect on money market assistance 1989-90	Effect on money market assistance 1989-90 to 1991-92	Change in public sector net liquid liabilities 1989-90	Change in public sector net liquid liabilities 1989-90 to 1991-92
Constant assistance rule		-	-	Indeterminate	
CGBR Sectoral Rule	a)	-5	-1	- 3½	- 6½
	b)	-5	-1	+ 2½	- 2½
PSBR Sectoral Rule	a)	-6	-12	- 3	- 7
	b)	-	+7½	- 3	- 7
PSBR Sectoral Rule (with Assistance Override)	a)	-6	-6¾	- 3	- 1¾
	b)	-	+5¼	- 3	- 9¼
CGBR Maturity Rule	a)	-2½	-7	- 6	-12½
	b)	-2½	-7	-	+ 3½
PSBR Maturity Rule	a)	-9	-19	-	-
	b)	-3½	-	-	-

18. The main points to emerge seem to be these :

a) a constant money market assistance rule will, by definition, lead to no change in the level of assistance. But because such a rule by itself has nothing to say about the way in which this is achieved - it is indifferent between forms of central government financing - the consequent contribution of the public sector to liquidity is indeterminate;

b) at the other end of the scale, a PSBR maturity based rule ensures that the public sector's net contribution to liquidity is zero. But in the process there might need to be a sharp decline in the stock of assistance over the next few years. This would be particularly the case if the local authorities continued to acquire liquid assets (case a). If this did not happen - because their access to the PWLB was restricted (case b) - then the change in assistance might be much less;

c) either of the CGBR rules mean that the level of assistance is not dependent upon the activities of the local authorities. This may seem an advantage but the other side of the coin is that the public sector contribution to liquidity will depend upon how the local authorities behave. A CGBR based funding rule will do nothing to offset the liquidity effects of local authority transactions;

d) the current PSBR sectoral rule should actually lead to a rise in money market assistance if the LAs' access to the PWLB were successfully restricted, but not otherwise - though the result also depends upon the behaviour of the banks and building societies. While by definition it has a neutral impact on the M4 counterparts, it can be seen that it does not ensure that the public sector has neutral effect upon liquidity, when defined as changes in public sector net liquid liabilities.

e) the current rule with a money market assistance override should guarantee a manageable money market position. As defined above, on a central assessment, it would be unlikely to affect gilt purchases this year. But in the longer-run it could have a substantial impact, either way, depending on local authority developments.

mg.ee/dlcp/19.6-pps2

CONFIDENTIAL

From : D L C Peretz (MG)
Date : 19 June 1989
x 4460

PPS

cc PS/Sir P Middleton
Mr Scholar
Mr Odling-Smee

MONEY MARKET ASSISTANCE MEETING

To avoid any confusion at tomorrow's meeting the Chancellor might note that :-

i) all attending should have had my minute of 2 June and the attached paper.

ii) only Treasury attendees will have seen Sir Peter Middleton's covering minute of 5 June.

iii) most of those coming would have seen the separate paper on the PWLB attached to Mr Scholar's minute of 16 June; but the Bank have only seen the "PWLB review" paper, not Mr Scholar's covering minute or the attached draft letter to the Deputy Governor on swaps.

DLCP

D L C PERETZ

GL MM

Ch

① I do not see how PEM's solution can be consistent with a "no change in funding policy" line — essentially it says funding policy may be overridden completely if money market considerations demand that.

② Announcing changes on the LA front on Wednesday may be tricky — or even announcing the intention to make changes. Wouldn't it provide an incentive to local authorities to rush in and borrow LTS now before the shutters come down? MCS is advising on this.

[illegible]

(3) The best option for an early announcement may be to say that we will no longer count TB's as pending — para 32. But is this too much of a mouse? ~~And what would be the context for announcing it later~~

[signature]

Not only a mouse, but I am not sure it is even true.

pso.vh/PEM/MMA

FROM: SIR PETER MIDDLETON
DATE: 5 June 1989

CHANCELLOR

cc Economic Secretary
Sir T Burns
Mr Wicks
Mr Scholar
Mr Peretz
Mr AJC Edwards
Mr Odling-Smee
Mr Riley
Mr Gieve
Mr Grice
Miss O'Mara
Mrs Ryding
Mrs Chaplin

MONEY MARKET ASSISTANCE

With the markets in such a nervous state, these are hardly the best circumstances in which to be submitting this note. But with the Bill mountain melting out of sight, we need to think ahead.

2. In my opinion, we should do the minimum needed to enable us to generate the short term interest rates we need; an essential requirement of any sort of monetary policy. The local authority measures will also help, but they will take time and are uncertain in the extent of their effect. So I favour Option 4(iii) in Mr Peretz' covering note - adjust our funding accordingly to the state of the money markets so that we can always maintain a small shortage. This seems far better than persisting with a funding rule which leads us apparently to take back - in the form of special deposits - funds we have put in the market by repaying debt; especially as deposits in any form will raise many unfortunate memories about the sort of controls we exercised when special deposits were in use.

p.p.

PETER MIDDLETON

FROM M C SCHOLAR
DATE 5 JUNE 1989
EXTN 4389

CHANCELLOR OF THE EXCHEQUER

LOCAL AUTHORITIES ROUND-TRIPPING

You asked me to think about what announcement you can make in Wednesday's debate preventing local authorities from borrowing from the PWLB for round-tripping reasons.

2. The annual circular which goes to local authorities simply says that the Treasury determines the rates at which local authorities may borrow from the PWLB. So far so good.

3. But to have any perceptible effect on round tripping, given the slope on the yield curve, would mean making a significant change in the formula by which the interest rate on local authorities' borrowing was defined. That would give local authorities ammunition for arguing that we had effectively changed their quotas of concessional borrowing in mid-year, without notice. In drawing up their 1989-90 budgets local authorities will have assumed that their borrowing quotas will be what they have been told they will be.

4. You may not think much of this argument, and decide that you and Messrs Ridley, Rifkind and Walker will take the risk of legal challenge in order to preserve your essential freedom to vary interest rates. But there is, Miss Wheldon thinks, a significant risk of a judicial review challenge from litigious local authorities. This is especially so when they are threatened by the possible drying-up of their borrowing from the market, given the swaps and options imbroglio. And you would not, if you accepted a recommendation that local authorities should be given a period of notice for changes in the formula, prejudice your freedom to alter interest rates generally, since all that is at issue is the link formula for this particular part of the market.

5. We want to be sure that any changes we make hit the right target. Much of this "round-tripping" seems to be by local authorities not round-tripping as such (ie borrowing from the PWLB and depositing short-term), but by county councils selling assets and using the proceeds not to repay debt, or to reduce their pre-existing PWLB borrowing programme, but to make deposits in the market. Raising PWLB rates would, of course, raise the borrowing costs of a significant number of councils who have no money-market deposits and defensible and well-established PWLB borrowing programmes, as well as of those which are "round-tripping".

6. It would, I think, be better to wait for FIM's paper assessing these arguments before making a substantial announcement. Nor do I think you could sensibly say you were thinking of doing something to make PWLB borrowing less attractive: there would be too much risk of precipitating a great deal of forestalling by local authorities.

7. If, nevertheless, you think it best to say something I think it would best be confined to announcing that you have local authority PWLB borrowing under review, and that you will be taking action to remove the financial penalty which discourages early repayment of PWLB loans.

8. But, for my money, it would be best to try to avoid commenting on this at all on Wednesday. I have asked FIM to speed up their paper, so that we can let you have it by the end of next week if possible.

MCS

M C SCHOLAR

FROM: A C S ALLAN
DATE: 6 June 1989

SIR P MIDDLETON

cc PS/Economic Secretary
Sir T Burns
Mr Wicks
Mr Scholar
Mr A J C Edwards
Mr Odling-Smee
Mr Peretz
Mr Riley
Mr Gieve
Mr Grice
Miss O'Mara
Mrs Ryding
Mrs Chaplin

MONEY MARKET ASSISTANCE

The Chancellor was grateful for your minute of 5 June, covering Mr Peretz' minute of 2 June and the MG paper on money market assistance.

2. He feels that the proposed moves on local authority financing are clearly desirable, and should be pursued as quickly as possible. He will want to hold a meeting in due course to discuss the other issues. On reflection, he does not feel that it is possible to make a substantive announcement in the Debate tomorrow: even to say that we have local authority PWLB borrowing under review runs the risk of encouraging forestalling.

A C S ALLAN

mg.ee/dlcp/19.6-pps

CONFIDENTIAL

From : D L C Peretz (MG)
Date : 19 June 1989
x 4460

PPS

cc PS/EST
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Scholar
Mr A Edwards
Mr Odling-Smee
Mr Riley
Mr Gieve
Mr Grice
Miss O'Mara
Mrs Ryding
Mrs Chaplin

Sir A Walters - No.10

Mr George)
Mr Coleby) B/E
Mr Plenderleith)
Mr W Allen)

pwp

MONEY MARKET ASSISTANCE

Sir P Middleton suggested it would be helpful to have an annotated agenda for tomorrow morning's meeting. One is attached.

DLCP

D L C PERETZ

mg.ee/dlcp/19.6-mma

CONFIDENTIAL

Sec 29(1) [a(ii)] 35

Pub LA's note later

Money Market Assistance

Annotated Agenda

Paper : Peretz, 2nd June, covering MG paper on "Money Market Assistance"

1. How did we get where we are? (Paras 3-5 of paper).

May be worth a short discussion. The full fund rule by itself might be expected to lead to a gradual rise in money market assistance (MMA), to match the gradual increase in MO. The reasons MMA have fallen are (a) the switch in the l.a. position, with l.a.s in effect providing "assistance" to the banks, rather than the Bank of England; and (b) gilt sales (particularly in 1988-89) by banks and building societies.

2. Possible Action on Local Authority Financial Transactions (Paras 6-9)

This has now been followed up with separate recommendations :

- to limit l.a.s' scope for financial intermediation in future, preferably by taking powers to cap the level of each authority's investments.

- immediate removal of the disincentive for the premature repayment of low interest rate PWLB debt.

Both changes are likely to take some time to have any substantial impact on the l.a. position.

3. Funding Rule (paras 10-35)

Do we want to retain a funding rule (that is a rule designed to limit the public sector's contribution to some definition of liquidity). In that case the options are :-

i) stick with the present M4 counterparts rule

ii) consider a move to a rule based directly on the liquidity of Government borrowing instruments (a maturity based rule)

iii) adapt the present rule to remove Treasury bills bought by non-banks/building societies from the definition of "funding"

If we are more concerned to avoid difficulties in the money market, or to avoid alternative ways of dealing with them, than to stick to any particular <u>funding</u> rule, then there is another option :

iv) modify gilt purchases as necessary to keep MMA and Treasury bill issue within desired bands.

In each case (other than (i)), how would the change best be announced and presented?

4. <u>Other action to mop up money market surpluses</u> (paras 36-45)

The options are :

i) Voluntary deposit schemes (paras 40-42). Do they have anything to offer not achieved by the stepped up Treasury bill tender?

ii) Mandatory deposits (paras 43-45). The questions here are :

- name and presentation. (Could they be presented as no more that a standard "required reserve" ratio scheme, on US/German lines?)

- in what circumstances could they be used, when an increased Treasury bill tender could not? (see para 44(i)).

- while there is no need for a decision one way or another now, should we proceed with contingency work? (para 45)

MINUTES OF A MEETING HELD AT 3.30PM ON WEDNESDAY 27 SEPTEMBER IN ROOM 47/2, HM TREASURY

Those present: Economic Secretary
Mr Scholar
Mr Peretz
Mr Grice
Miss O'Mara
Mrs Davies
Mr Rich
Ms Ryding
Miss Haskins

Mr George)
Mr Plenderleith) Bank
Sir N Althaus)
Mr Allen)

Mr Patterson)
Mr Butler)
Mr Ward) DNS

The Economic Secretary began the meeting by thanking Sir Nigel Althaus for his contribution to funding meetings over the years and wished him well for the future.

Funding Arithmetic in 1989-90

2. Introducing the MG paper, Mr Peretz explained that the forecasters were currently in the middle of the September forecast round which, when it was completed, would give a new PSDR figure for the financial year. But for the time being the funding arithmetic assumed the June forecast PSDR, which was still believed to be a reasonably central estimate. There had been a number of fairly large changes to the funding arithmetic since the July meeting. In particular, a larger outflow from National Savings was now expected; banks and building societies were now assumed to sell substantially more gilts than expected before the summer; and for the first time the arithmetic assumed there would be a contribution to funding from an outstanding level of Treasury bills at the end of the financial year.

3. Taking these factors together with purchases so far and allowing for the forthcoming reverse auction, implied buying in of around £½bn per month would be needed to achieve a full fund.

However around half of this was accounted for by the Treasury bill assumption. Since the paper was written the Bank had made more purchases, but this was broadly balanced by further intervention. We would need to give some consideration to whether or not gilt purchases should be made to match the Treasury bill contribution to funding. When this had been considered earlier in the year, the decision was that deliberate over-funding might be an option. It had also been concluded in the past that intervention should not necessarily be unfunded immediately. Again this could argue for some overfunding during the year if there were further substantial intervention in support of sterling.

4. Mr Plenderleith agreed that it was not necessarily sensible to match sales of Treasury bills with gilt purchases, but since it was in any case difficult to fine tune gilt purchases there was no need to take a precise view at this stage.

National Savings

5. Mr Patterson welcomed the inclusion of a forecast of £-1 3/4bn for the rundown of National Savings for the year as a whole, although he thought the outcome might even be closer to £2bn. August had seen a run down of £-650m of fixed interest certificates. By no means all of this had been from the 28th Issue where there was still some way to go. There had been very little re-investment in the 34th Issue. Taking all products together there had been a net repayment of £-350m for the month.

6. Continuing, Mr Patterson made a number of comments concerning cost of funding. In particular, although GER money was poor quality, it was very cheap. The Capital Bond was overpriced, although less than it had been, but inflows were still relatively low. He was not suggesting any immediate change, but there were quite significant differences in product terms. Mr Scholar asked about the prospects for variable rate products, should retail deposit rates generally change.

7. Mr George said that although it was by no means certain, a mortgage rise on 1 November was looking increasingly likely. Retail inflows to building societies were still reasonably

buoyant, although there was nervousness about the effect of water privatisation. If mortgage rates rose then deposit rates would rise too. Even if there were no general rise, there was likely to be an increasing number of special offers to attract retail funds. Mr Patterson commented that failure to move some National Savings variable rates promptly in that situation could lead to a large outflow right across the board, rather than as at present, from particular products in a controlled way. The two key rates would be for Income Bonds and the Investment Account.

8. Sir Nigel Althaus said that in his view the tax treatment of the Capital Bond made it unattractive and had necessitated paying expensive rates of interest. He asked whether better results could have been achieved by actually paying out interest once a year rather than accumulating it for the life of the bond. There was some discussion of these comments, and in response Mr Peretz noted that it would have been administratively expensive to pay interest each year but that holders already had the option of cashing in part of their holdings each year if they needed the cash flow to pay interest. Mr Patterson said the Capital Bond was basically a good product, and a useful addition to the National Savings armoury, and that there had in practice been relatively little criticism of the tax treatment in recent months.

Money Market Assistance

9. Mr Allen noted that no decisions were needed immediately. The decision to step up the tender to include 2 months bills had already been announced. This should mean that in the run up to December, the level of assistance would be rather higher than in September. As a result the technical position in the money markets should be more comfortable. This assessment was subject to the forecast being accurate, but there should be a reasonable margin of safety. The next decision would be whether and when to reduce the tender. The forecast for February and March was for large flows of funds into the market which could continue into the next financial year. In this case we would want to increase the tender quickly after January. We would be better placed to take the decision when the new forecast was available.

10. Mr Peretz said that he hoped a new forecast for the remainder of this year and a monthly profile into next year would be available by the time of the next funding meeting. At that meeting it might also be sensible to consider whether to aim buying in a little short of a full fund in order to keep the level of assistance up in the early months of 1990-91. The other unknown was local authority behaviour. We had recently changed the rules for early repayment of loans from the PWLB and it remained to be seen what effect this would have.

Gilt portfolio

11. Mr Peretz introduced MG2's paper. There had been little change in the relative costs of funding since the July meeting. The MTFS scenario implied that longs and mediums represented expensive funding and all scenarios supported selling index linked gilts. Looking at the ranges, longs were currently at the bottom of their range, so further purchases did not look particularly attractive. The position was rather different from mediums which were currently in the upper end of their range whereas ideally they would be at the lower end. Irrespective of cost consideration there were quality of funding arguments for purchasing ultra shorts. The Bank had purchased some shorts recently because that was the area of the market under pressure, but he hoped it would be possible to switch these into mediums at some stage.

12. Mr Plenderleith agreed with these conclusions and noted that the forthcoming reverse auction would be for mediums. In fact purchases had not been particularly concentrated in shorts and there had been a fair proportion of purchases of medium. He noted that the movement in the yield curve over the last day or so could alter the relative attractiveness of various maturities.

13. Mr George explained that until the trade figures the market had traded in a very narrow range and had been subdued. However, in the last 48 hours it had seen a fall of 2 points. He expected

this tone to continue. Against this background it should be relatively easy to pick up stock although this would not help the money market position.

Funding target for October

14. Mr Peretz noted that the forthcoming reverse auction would score in October's figures, but consideration needed to be given to gilt purchases on top of that. The funding arithmetic suggested an average of £500m per month to achieve a full fund, but the discussion suggested aiming short of that depending on market conditions. The Economic Secretary agreed that the Bank should aim for a figure of under £500, if possible, backing away from the market a little rather than taking all the stock that was offered.

Cathy Ryding

CATHY RYDING

Circulation:

Those present

PPS
Sir P Middleton
Mr Wicks
Sir T Burns
Mrs Chaplin
Sir A Walters - No. 10

FROM : M C SCHOLAR
DATE : 16 OCTOBER 1989
x 4389

CHANCELLOR

cc Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Wicks
Mr Peretz
Mr Grice
Miss O'Mara
Mr O'Donnell
Mrs Chaplin

FUNDING POLICY

I mentioned that we had had a proposition from the Bank of England for announcing a change in funding policy in the Mansion House Speech. I understand the Governor also mentioned this to you this morning.

2. The proposal as it emerged from my meeting on Friday, and as it has been written up in the attached submission which we have cleared with the Bank, was greatly modified from the Bank's original very radical suggestion, set out in Eddie George's letter of 12 October (which you will find behind the attached submission). The original proposal was a straightforward announcement that we were suspending the present funding rule, excluding all intervention from it, for the current financial year.

3. The Bank have this afternoon retreated still further from their proposal. They are now suggesting little more than a reaffirmation of the statements made in the last two Mansion House speeches that, to reverse the signs from the 1987 Mansion House Speech, net intervention will be unfunded "as and when appropriate, although not necessarily within the financial year in which the intervention takes place".

4. I think this would be a sensible and unremarkable thing to say. The action they are nowsuggesting is no more than we have been pressing them to do for some weeks (against objections from them that we risked disrupting the market!).

5. An alternative, which would be a change in the funding rule, is the idea we have discussed before of excluding Treasury bill sales to the non-bank non-building society sector from the definition of funding. It is now clear that if we do not do that this year's increased Treasury bill issue is going to require us to buy in £1½ billion or so more gilts than we would buy if we stick to the full fund rule : a somewhat bizarre result.

6. I did not like the Bank's original proposal at all. It would in my view be wholly wrong to abandon what has proved a useful rule simply because of the short-term market circumstances. Nor do I think, for the reasons argued in the attached note, we could expect much impact on the exchange rate, even from the Bank's original more radical proposal. Indeed the effect could even be perverse. Events in the equity market have in any case ruled this proposal completely out of court.

7. The risk in including the Treasury bill proposal is that it will look a footling change, and may confuse the main message of the speech.

8. My inclination is, nevertheless, to include it; to reiterate the flexibility we have reserved for ourselves on defunding intervention; to announce the conversion; and to give some general indication of how the buying-in policy has developed - ie that we are not targeting the long-dated end of the market.

[but say nothing about reverse auction?]

MCS

M C SCHOLAR

mg.ee/dlcp/16.10-dm

SECRET

From : Cathy Ryding (MG1)
Date : 16 October 1989
x 4612

1. MR SCHOLAR
2. CHANCELLOR

cc Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Wicks
Mr Moore
Mr Peretz
Mr Walsh
Mr Grice
Mr O'Donnell
Miss O'Mara
Miss Wallace
Mrs Chaplin

Mr George - B/England

In the light of events in the equity markets the Bank now favour a further softening of their proposal. They now suggest the form of words at annex B, without any dramatic action in the gilts market the next day and without announcing the cancellation of the next reverse auction. MLS 16/10

FUNDING POLICY

As you know, we have since the September funding meeting been following a policy - confirmed and strengthened in your response to Mr Peretz' minute of 29 September - of attempting for the time being to minimise gilt purchases so far as is possible without causing market disruption or leading people to believe that we no longer thought our funding policy to be sound. There are two reasons for this. First, it should help with money market management (and we are also conscious that the increased Treasury bill issue has led to some rather low quality "funding"). Second, and more important, we do not want to put downward pressure on long-term interest rates at a time when we are taking other action, by way of intervention and short-term interest rates, to support the exchange rate.

2. The Bank proposed at the end of last week that, given the fragile state of the exchange markets and the risk of further upward pressure on short-term interest rates, it would be sensible to take the policy a step further. The attached letter from Mr George sets out the Bank's initial proposal, which was modified in the course of a discussion on Friday chaired by Mr Scholar. The initial proposition, as you will see, was for a clear suspension of the full-fund rule for the current financial year,

announcing in the Mansion House Speech that we would not, this year, be seeking to offset past or future foreign exchange market intervention by de-funding. What is now proposed is in effect a reaffirmation, as in previous years, that intervention may not be unfunded immediately. The Bank have provided the attached draft passage for the Mansion House Speech, as an illustration. The Bank also propose that they should seek on Friday to emphasise the message to the GEMMs.

3. The aim would be to bring about a sharp rise in yields at the longer end of the market, by explicitly slowing the Bank's buying in operations, the rise in gilt yields providing support for the exchange rate.

4. Although the proposition was made before today's sharp fall in the equity market, and significant rise in the gilts market, the Bank still see a strong case for going ahead.

Announcement and Mechanics

5. Following the announcement in the Mansion House Speech, the Bank would want to underline its significance by calling in the GEMMs to explain to that the Government in fact intends to unfund very little intervention in the current financial year, unless circumstances change; and that against this background they will be dramatically cutting back their buying in operations. However, the Bank would reassure the GEMMs that they would still be prepared to undertake switches and provide market support in periods of turbulence.

Likely Effects

6. The effect the Bank would be looking for would be a rise in yields of the order of ¼-½% - roughly the equivalent to a fall in prices of between 2 and 5 points. The sums at stake are not large however, in relation to foreign exchange flows. Intervention in the foreign exchange market so far this year has amounted to £5 billion. So a decision not to unfund this over the rest of the financial year might in principle reduce our buying in target by

£1 billion a month over the rest of the financial year (or more if we continue to intervene) - though in practice the Bank do not think buying in on the scale required for a full fund is now practicable in any case.

7. This all suggests that the impact of the policy change on financial flows across the exchanges, and hence on the exchange rate, is likely to be relatively modest. Nevertheless it should be in the right direction, and were there no complications, it would clearly be worth going ahead on the argument that in current circumstances any help is worth having.

Risks

8. There are however a number of risks, although the Bank think there are steps we can take to minimise them.

9. First, there is the risk that a fall in gilt prices will actually be counter productive, putting off potential foreign investors. This is a matter of judgement, but the Bank believe that a sharp clean fall in prices, leaving the market to trade steadily at its new lower level, should have at most only a short-term adverse effect on investors' confidence. The Bank believe they can bring about an orderly fall in prices, and will be helped by the fact that most GEMMs are already expecting a statement on funding policy of some kind in the Mansion House Speech. So there should not be too much of a blood bath in the market, although, unlike GEMMs, most financial institutions will not be able to protect themselves by going short on gilts on Thursday.

10. Second, there is the risk of spill over into the equity market. But the Bank believe that should be limited [to perhaps 25 points on the index] (indeed, today we have seen a rise in the gilt market at the same time as a fall in the equity market). If necessary, the Bank can limit the damage by stepping in to support the gilt market to prevent it falling too far. For this reason any impact on water privatisation should be slight.

11. Third, we could face some criticism for hampering the corporate bond market. But of course Government demands on the sterling bond market would remain a great deal less than a few years ago, even if the net repayment was not as great as it would have been under a full unfund policy.

12. Fourth, and more important perhaps, is that the move might be viewed by some as a return to overfunding, reflecting a lack of faith in current monetary policy and thus undermining credibility in the market. In fact it is a pragmatic implementation of existing policy. But both IDT and the Bank's press office would need to be ready to provide a tough defence with ready answers to such questions as how long we plan to overfund, and by how much, and whether we would compensate for this overfund in due course.

Consequentials

13. If you are attracted to this proposal, the Bank argue that it would be sensible to abandon for the time being the conversion operation you were to have announced in the Mansion House Speech, and to announce that the reverse auction that we said was a possibility for the New Year would be cancelled. The Bank believe that announcing the conversion operation could detract from the message, and cancelling the reverse auction would strengthen it : though neither is inconsistent with slowing down our buying in operations.

14. We will also have to consider the implications for the cancellation operation you planned to announce in the Autumn Statement, though since this relates to the cancellation of gilts that have already been bought it is not obvious that it need be affected.

Alternative

15. There is a further option for a reference to funding in the Speech which could either replace the proposal discussed above, or be combined with it. A fair proportion of the increased Treasury bill issue has been sold to the non-bank non-building society sector. Under the funding rule, these sales count as funding. But they are very poor quality funding; and paradoxically by

purchasing gilts to compensate for the extra funding by this method we worsen the money market position again, necessitating some further sales of Treasury bills.

16. If you were to announce that Treasury bills would no longer count as funding, whoever bought them, this would reduce the buying in target for the current financial year by £1½ billion on present figures. A draft paragraph for the Mansion House Speech is attached.

17. The Bank do not favour this as an alternative to their proposal, arguing that the markets are expecting a major announcement on funding policy, and that simply removing Treasury bills from the definition on its own would be seen as an inadequate response. Furthermore if their proposal were implemented fully they say the Treasury bill issue would fall back by the end of the year so they argue the change would then be unnecessary.

18. There is also a risk that singling out Treasury bills for exclusion from the funding arithmetic in this way could focus attention on some other components that represent similarly poor quality funding - eg CTDs and some national savings products. Against this we could argue that in fact we had taken steps to run down most of the other poor quality funding instruments, while it has been necessary to increase the Treasury bill issue for money market management reasons. Also Treasury bills are marketable, providing a further reason to distinguish Treasury bills from other poor quality funding instruments.

<u>Summary</u>

19. The market is expecting something on funding policy in the Mansion House Speech, and the Bank believe it would be helpful to the operation of policy to bring about a downward adjustment in the gilt market.

20. Given the arguments set out above, are you attracted by :-

i) the Bank of England's proposition, modified after discussion with the Treasury, for a reaffirmation in the Mansion House Speech that intervention will not necessarily be unfunded in the current year (draft passage attached), to be subsequently explained to the gilt market in the way the Bank propose (paragraph 5);

ii) either in addition, or as an alternative, an announcement that from henceforth Treasury bills purchased by the non-bank non-building society sector will not count as funding, for the purposes of the funding arithmetic (see draft passage attached).

MCS

p.p. CATHY RYDING

mg.ee/dlcp/16.10-para

Annex A

CONTRIBUTION TO MANSION HOUSE SPEECH ON TREASURY BILLS

In response to the current money market position, the authorities have been issuing increased numbers of Treasury bills. Although most of these bills have been bought by banks and building societies, some have been sold to the private and overseas sector and hence count as funding within the present definition, requiring additional purchases of gilts under the full fund rule. It is bizarre that sales of such short-term market instruments should be defined as funding. Since it is now clear that the increased Treasury bill issue is going to have to continue for some time, I have concluded that it is now only sensible to remove Treasury bills from the definition of funding irrespective of who buys them.

Annex B

FAX TO MR SCHOLAR (HMT)

Since the mid-1980s we have pursued a policy of fully-funding the Public Sector Borrowing Requirement, or more recently fully-defunding the Public Sector Debt Repayment. The rationale for this policy is to ensure that Public Sector financial activity has a broadly neutral effect on the liquidity of the economy. I see no reason to depart from that general policy guideline.

Equally I have made it clear on earlier occasions that we do not seek to implement the fully-fund policy rigidly month by month or even necessarily year by year. There can be circumstances where it would be sensible to depart from the general guideline in the short-term in either direction. In our present situation the general rule would require that net intervention in the foreign exchange market should be sterilised - and so it should over time. But it is not necessary that it be sterilised immediately, and indeed the impact of intervention would be likely to be reduced if it were fully sterilised in the course of the current financial year.

Letter From
Bank of England
Executive Director

BANK OF ENGLAND
LONDON EC2R 8AH

E.A.J. GEORGE
EXECUTIVE DIRECTOR

12 October 1989

M C Scholar Esq
H M Treasury
Parliament Street
London
SW1P 3AG

Dear Michael,

1 As I mentioned to you on the telephone, we have been thinking about what options are available for protecting ourselves against the contingency of continued sterling weakness in the near term, and possible associated market pressure for yet a further rise in short-term interest rates.

2 We think that the most practical option on the domestic side would be to amend funding policy by suspending the full-fund rule. The most natural opportunity for the Chancellor to announce such a change would be in his Mansion House speech next Thursday, which is also the day on which the provisional money figures for September will be published. I thought that it might be helpful to set our ideas on paper now, in time for a decision to be taken in that context.

3 The purpose of making the proposed change would not be to try to restrain broad money growth in the way Tim Congdon has suggested. Indeed one of the effects would be to leave less room for private sector borrowers in the bond market, forcing them back into the banking system, and it is not clear in present circumstances that the overall effect on broad money would be very large or even favourable. Rather, the objective would be to

7/120

provoke a rise in bond yields, and also falls in the prices of other sterling capital market assets, increasing their attraction compared with other assets, including foreign currency assets, which would provide indirect support for the exchange rate, and help to contain the upward pressure on short-term interest rates.

4 Of course we could probably achieve something of these objectives by changing funding policy without making any announcement - indeed we are already limiting our gilt purchases as far as we sensibly can. But in the foreign exchange market conditions that we may need to protect ourselves against, we may need to achieve an abrupt effect and therefore need an announcement.

5 Plainly we could not say that we had abandoned the full-fund rule without giving some indication of what our new approach to funding would be. We suggest that the announcement should say that the full fund rule was being suspended for the current financial year in so far as we would not seek to offset foreign exchange market intervention by de-funding. I attach a separate note which identifies the consequence of this particular change for the funding arithmetic and for money market assistance. The figuring is extremely rough but we will be able to refine it when we have the autumn forecast. As it stands, it suggests that, rather than underfunding by some £2 billion this year as originally intended so as to offset overfunding in earlier years, we might end up with an overfund of around £3 billion, assuming no further foreign exchange market intervention. If we intervened more from now on to support sterling, the extent of the overfund would be greater. The net injection of funds into the money market over this financial year might be about £6-7 billion less than we have been envisaging, so that the net increase in the Treasury bill issue over the year might be quite small (and there would be a substantial fall between now and the end of the financial year); further intervention would mean an even smaller net injection of funds over the financial year, or a net withdrawal. This would mean that the consequences for the funding arithmetic of net purchases of Treasury bills by the M4 private sector would not be very great, and we think it would be unnecessary to complicate the presentation of the proposed change

by including in the announcement a statement that we would not aim to cover them by de-funding in the gilt market.

6 What we are proposing would amount to a clear change in funding policy. From the Chancellor's viewpoint it need not however be seen as a sharp break with the past, because he has already said that we will not necessarily aim to offset through funding operations within the financial year foreign exchange intervention which takes place towards the end of the year. The change could perhaps be explained as a decision not to sterilise foreign exchange intervention (in an M4 sense) for the time being. We think that the generality of financial commentators would see it as a sensible and pragmatic means of increasing the effectiveness of intervention in present circumstances. Another possibility (additional rather than alternative) would be to explain the change explicitly along the lines set out in paragraph 3 above, which would underline the link with the exchange rate and might therefore provide it with more substantial underpinning.

7 An alternative possibility would, of course, be to relate the change in funding policy to the amount of the additional Treasury Bills taken up outside the monetary system. This, in our view, would be far less effective, both because the amount of additional funding would be less (some £1 1/2 billion only on the tentative arithmetic in the attached note) and because it is likely to be seen by the markets as a small and essentially technical adjustment with its implications for the exchange rate and short-term interest rates more difficult to understand. It would also be much more complicated to present to a broad audience rather than the specialist analysts; for the broader audience it would be likely to involve a wholly new departure but one which did not promise much practical effect.

8 The change we propose in paragraph 5 would have a number of consequences:

(i) It would look inconsistent with the proposed change to announce the cancellation and conversion operations we have been planning. It would however be sensible to announce that, in the light of the policy change, we would not be holding the reverse auction we had been envisaging for early next year.

(ii) The change would be likely to lead to a fall in equity prices, which would have implications for the water privatisation. We recognise the sensitivity of this question but think that it might on balance be more helpful to that operation to get a fall in equity prices out of the way in advance, so that there was a better chance of a more stable market environment for the privatisation itself rather than run a greater risk of having to sell into a market which was overhung by macro-economic uncertainties, even though this might be at the cost of a lower level of prices.

9 Of course we would be very happy to come over and discuss this proposal if it would be helpful.

Yours ever,

Eddie.

CONSEQUENCES OF THE PROPOSED CHANGE IN FUNDING POLICY FOR THE FUNDING ARITHMETIC AND FOR MONEY MARKET ASSISTANCE

The papers for the September funding meeting suggested that the funding arithmetic for the current financial year might be as shown in the first column below (figures in £ billions):

PSBR(+)/PSDR(-)	-12.1	-12.1
Intervention	- 2.7	- 5.2
Maturities	9.8	9.8
Total for funding	- 5.0	- 7.5
Non-gilt funding		
National Savings	- 1.7	- 1.7
CTD sales to M4PS	- 0.1	- 0.1
Treasury bill sales to M4PS	1.5	1.5
OPS debt sales to M4PS	- 1.4	- 1.4
Total non-gilt funding	- 1.7	- 1.7
Gilt funding		
Net sales to M4PS and overseas needed for full fund	- 3.3	- 5.8
Net sales to banks and building societies	- 2.0	- 2.0
Required gross sales	- 5.3	- 7.8

this banks selling gilts.

The second column of the table above adds to the intervention total the $4 billion (= £2 1/2 billion) we have done since the end of August, but makes no other changes to the table. On this rather artificial basis, secondary market purchases of gilts from the private and overseas sectors this financial year would need to be £5.8 billion, and total secondary market purchases would need to be £7.8 billion; this would imply a target of around £1 billion a month from now on.

If we were to announce that we would not offset intervention by defunding this financial year the arithmetic would be radically different: secondary market purchases of gilts from the private and overseas sectors this financial year would need to be less than £1 billion, and it is likely that, with total secondary market purchases much lower, purchases from banks and building societies would also be much lower. Total gross purchases might be £6-7 billion less than if we stuck to the full-fund rule.

As to the money market, the Treasury summer forecast envisaged a net injection of funds into the market of some £8 billion over the current financial year*. At the beginning of the year the stock of money market assistance was about £4 billion; if we wanted to have a similar-sized stock at the end of the year the Treasury bill issue would on the basis of the forecast need to increase by £8 billion over the year. If however the funding objective were to be changed so that gross purchases of gilts were to be £6-7 billion less than implied by the full-fund objective, the necessary increase in the Treasury bill issue over the year would be correspondingly smaller - say £1-2 billion. This would imply a fall in the Treasury bill issue between now and the end of the financial year. In addition, the rise in bond yields and the associated reduction in the steepness of the yield curve might lead local authorities to borrow less from the PWLB and increase their deposits with banks and building societies by less; if so the necessary increase in the Treasury bill issue would be smaller still.

All this figuring is based on the assumption that we do no further foreign exchange intervention this financial year. If we needed to provide further support for sterling, then the funding objective on the new basis of funding policy would be unchanged but the degree of overfunding that was implied would be greater. Moreover if the additional intervention was on any substantial scale there would be no need for any major increase in the Treasury bill issue over the financial year, and the recent within-year increase could be largely reversed; moreover the amount of assistance could be higher at the end of the financial year than it was at the beginning.

---

*The papers circulated for the September funding meeting suggested £6 1/2 billion but this was partly based on the FSBR forecast, which of course pre-dates the summer forecast.

COVERING SECRET

FROM: CATHY RYDING (MG1)
DATE: 23 October 1989
EXT: 4612

ECONOMIC SECRETARY

cc Chancellor
Sir P Middleton
Mr Wicks
Sir T Burns
Mr Scholar
Mr Peretz
Miss O'Mara
Mr Grice
Mr Rich
Mrs Davies
Mrs Chaplin
Mr Patterson) DNS
Mr Wilson)
Mr Plenderleith - BoE

Sir A Walters - No 10

FUNDING MEETING

There are four items on the agenda for the meeting on Wednesday 25 October.

i. Funding Arithmetic

ii. National Savings

iii. Money Market Assistance

iv. Gilt Edged Funding and Gilt Portfolio Management.

2. I attach papers on these items. The papers on Funding Arithmetic and Gilt Portfolio Management have been written jointly by the Treasury and the Bank.

Cathy Ryding

CATHY RYDING

COVERING SECRET

108g/mg1.pa/Ryding/1.18.10not

FUNDING ARITHMETIC 1989-90

This note discusses the funding arithmetic for this year based on an M4 funding rule, and following the announcement in the Mansion House speech, excludes sales of Treasury Bills to the M4 private sector and overseas from the definition of funding.

The table assumes the September forecast PSBR surplus of £13.3 billion. This compares with the June forecast figure of £12.1 billion used last month. In line with DNS' latest assessment, National Savings are assumed to contribute £-2.0 billion over the full year, compared with £-1750 last month. As in earlier months, CTDs assumed to be run down by £-100 million.

The table allows for £2.0 billion of intervention in October so far, but assumes no net intervention beyond that. This gives a figure of £4.8 billion for the year as a whole, after allowing for intervention in April to September. Banks and building societies are assumed to run down their holdings of gilts by £2.4 billion over the financial year as a whole, reflecting experience to date. This compares with assumed disposals of £2 billion in last month's arithmetic.

In line with the Chancellor's announcement in the Mansion House speech, sales of Treasury Bills to the M4 private sector and overseas have been removed from the definition of funding. Without this change, Treasury bills would have contributed £1.4 billion to funding April to September.

On these assumptions (and allowing for the carryover from last year), the arithmetic suggests gross gilt buying-in of £9.5 billion for the year as a whole if we are to achieve a full fund, an average of £0.8 billion per month. Gilt purchases April to September amounted to £4.2 billion and allowing for purchases so far in October leaves £4.7 billion to be achieved over the remainder of the year, an average of £930 million from November to March. If instead of assuming a full fund, only half of this year's intervention is funded - broadly equivalent to ignoring October's intervention - the monthly buying-in requirement from November to March falls to £450 million. The buying-in requirement will be increased by any sales of index-linked stock and any further intervention.

TABLE 20 SECRET 18/10/89

FUNDING : FINANCIAL YEAR 1989/90

£ million

	Forecast 1989-90	Outturn April-Sept 89	Residual Oct 89 - Mar 90
Within Year Contribution to Funding Requirement:			
1 PSBR (+)/PSDR (-)	-13300	-445	-12855
2 Intervention (increase in reserves +)	-4825	-2825	-2000
3 Maturities	9789	5720	4069
4 TOTAL FOR FUNDING	**-8336**	**2450**	**-10786**
FUNDED BY:			
Non-gilts			
5 National Savings	-2000	-910	-1090
6 CTDs sales to M4PS	-100	126	-226
7 Other public debt sales to M4PS and overseas	-1389	-1110	-279
8 Total non-gilt funding	**-3489**	**-1894**	**-1595**
Gilts			
9 Gilt sales to M4PS and overseas needed for full fund within year	-4847	4344	-9191
10 Net gilt sales to banks, building socs and other public sector	-2432	-2432	0
11 Required gross official gilt sales	**-7279**	**1912**	**-9191**
12 Actual gross gilt sales to date		-4195 (-699)	
13 Over(+)/Under(-)funding	-2199	-6107	3908
14 Remaining gross gilt sales required			**-5283 (-881)**
15 Gross gilt sales required over whole year	-9478		

(Figures in brackets in lines (12) and (14) are monthly averages)

Relationship between lines:

(4)= (1)+(2)+(3)
(8)= (5)+(6)+(7)
(9)= (4)-(8)
(11)= (9)+(10)
(13): Col(1) Underfunding required in 1989-90 to offset previous cumulative overfunding
Col(2) Line (12) - line (11)
Col(3) By residual from cols(1) and (2)
(14)= (11)+(13)
(15)= (12 col 2)+(14 col 3)

NATIONAL SAVINGS (Note by MG1 Division)

1. This note reports the latest position on National Savings and comments on the prospects for the rest of 1989-90.

Results for September 1989

2. There was a total net repayment of £362 million. Repayments of fixed interest certificates were £580 million, primarily from matured 28th issue. The maturity period has now ended, and the level of repayment is falling. Sales of 34th issue were £66 million, and included reinvestment of £61 million from matured certificates. This continues the pattern observed in recent months - a very low level of new investment.

3. In contrast to August when index linked certificates recorded a net inflow of £59 million, in September there was a net addition of only £3.6 million. Repayments were high in August (£40 million) but the accrued interest of £58 million (which included the final supplements for the 1st and 2nd issues) offset this. Repayments in September were £42 million but with accrued interest of only £17 million a much smaller net addition resulted.

4. The pattern of modest net inflows from Income Bonds (33 million) continued. Sales of Capital Bonds totalled £28 million; since Capital Bonds were introduced in January, £366 million has been invested.

October to December 1989

5. The attached table shows the DNS forecast for this period. The forecast is for the net outflow experienced in the past 12 months to continue. The main reason is repayment of matured fixed interest certificates earning the modest GER of 5.01%. The peak of repaying maturing 28th issue has passed, while the

29th issue (which starts to mature on 15 October) has only some £350 million invested. The level of outflow is therefore forecast to abate somewhat over the period, to a total of £915 million.

6. Modest inflows from other main products are forecast as follows (it should be noted that in the past, the performance of the Investment Account has been particularly volatile):

	£ million
Income Bonds	+ 96
Investment Account	+ 95
Capital Bonds	+ 60
Index-linked certificates	+ 33

7. Outflow for April to September was £905 million. The DNS forecast is for a further outflow of £609 million in the next three months resulting in a total outflow of £1.5 billion to the end of December 1989.

Prospects for 1989-90 as a whole

8. The funding arithmetic assumes a total outflow of £2 billion.

CONFIDENTIAL

FUNDING FORECAST OCTOBER 1989 TO DECEMBER 1989

£ million

TABLE D1: ANALYSIS BY PRODUCT

	SEPTEMBER			OCTOBER			NOVEMBER			DECEMBER			3 MONTHS TOTAL CONTRBTN	AMOUNTS INVESTED AT END OF DEC	
	NET INFLOW	GROSS ACCRUED INT	TOTAL	NET INFLOW	GROSS ACCRUED INT	TOTAL	NET INFLOW	GROSS ACCRUED INT	TOTAL	NET INFLOW	GROSS ACCRUED INT	TOTAL			
CAPITAL BONDS	28	0	28	20	0	20	20	0	20	20	0	20	60	426	
NSC FIXED INTEREST	-514	60	-454	-355	60	-295	-370	60	-310	-370	60	-310	-915	8,974	[of which £4,200m matured certificates]
NSC INDEX LINKED	-14	17	3	-15	23	8	-15	28	13	-15	27	12	33	4,338	[of which £2,500m matured certificates]
YEARLY PLAN	5	3	8	3	3	6	0	3	3	0	3	3	12	605	
SAYE	-9	6	-3	-3	3	0	-3	3	0	-3	3	0	0	453	
INCOME BONDS	33	0	33	28	0	28	37	0	37	31	0	31	96	7,954	
INVESTMENT ACCOUNT	-40	65	25	-30	65	35	-35	65	30	-35	65	30	95	7,869	
PREMIUM BONDS	8	0	8	8	0	8	8	0	8	8	0	8	24	2,349	
ORDINARY ACCOUNT	-6	3	-3	-5	3	-2	-5	3	-2	-5	25	20	16	1,606	
DEPOSIT BONDS	-17	10	-7	-20	10	-10	-20	10	-10	-20	10	-10	-30	797	
TOTAL DNS	-526	164	-362	-369	167	-202	-383	172	-211	-389	193	-196	-609	35,370	

DEPARTMENT FOR NATIONAL SAVINGS
STATISTICS UNIT 01 605 9316
12 October 1989

FUNDING MEETING: MONEY MARKET ASSISTANCE

The attached tables show the latest forecast of money market assistance over the rest of 1989-90 and into 1990-91.

2. For the first time the tables use an updated CGBR forecast for the whole of this year, and into next year. The figures are consistent with the CGBR produced by the September forecast. Both tables use the illustrative assumption of a weekly Treasury Bill tender of £800m (£200m of 2 month bills, £500m of 3 month, £100m of 6 month bills) until the end of November, and from then on issues to meet the amount of maturing 3 and 6 month bills only.

3. The tables use two different assumptions about funding policy. Tables A and B assume a full fund in both years. Table C assumes half of this year's intervention is unfunded. Table D assumes this intervention is carried forward and fully funded in 1990-91. Again these assumptions are illustrative and we may need to reconsider the profiles once decisions have been taken on the funding strategy.

4. Taking the full fund example first (tables A and B), the level of assistance turns negative in March. Assistance moves rapidly more negative in 1990-91, reaching a low of £-7.8 billion.

5. On the second set of tables (C and D), which assume only half of this year's intervention is funded, the position is rather more comfortable this financial year. The level of assistance is projected to end this year at £2 billion. However, partly because this year's overfund is assumed to be recouped next year, assistance turns negative in 1990-91, although not as quickly and by lesser amounts than in the full fund case. Assistance reaches a low of almost £-6.6 bn in September, ending up the year at the same level as the full fund example.

6. The numbers are still very uncertain, not only for the year as a whole but particularly so for the individual months. However, there is one clear message; simply failing to fund even all of this year's intervention (unless there is substantially more intervention) will not prevent assistance becoming negative next year. We will need to increase the Treasury Bill tender quite sharply if we are to maintain a comfortable position in the money markets. How big this increase needs to be will depend on decisions on how far to depart from a "full fund" this year, and how much of this year's overfunding should be recouped in 1990-91.

TABLE A

MONEY MARKET ASSISTANCE FORECAST 1989/90
(assumes full fund during 1989/90)

SECRET £ millions nsa 20/10/89

	OUTTURN						FORECAST						TOTAL 1989/90
	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	
INFLUENCES ON BANKERS' BALANCES													
1 CGBR (+)	-362	1291	1085	-1197	1549	15	-2524	-650	-3965	-4174	-122	2125	-6929
2 CG bank deposits (+)	-95	-60	25	17	43	47	0	0	300	-300	0	0	-23
3 Reserves etc (+)	86	-657	-1519	-156	-356	-187	-2000	-26	-65	0	0	0	-4880
4 Notes & Coin (-)	71	53	-350	166	-269	-183	588	-489	-1402	1801	50	-125	-89
5 National Savings (-)	41	70	12	46	269	359	202	211	196	198	198	198	2000
6 CTDs (-)	-84	-8	16	-133	-22	29	-30	0	0	44	44	44	-100
BGS (-)													
Gross sales (-)	875	1203	903	276	512	479	650	836	835	1236	836	836	9478
Maturities (+)	825	533	1248	23	1742	1291	806	163	350	1210	954	644	9789
7 Net sales (-)	1700	1736	2151	299	2254	1770	1456	999	1186	2446	1790	1480	19267
8 Other	-1312	-147	53	451	-364	335	300	600	300	0	0	0	216
9 TOTAL INFLUENCES ON BANKERS' BALANCES	45	2278	1473	-507	3104	2185	-2008	645	-3450	15	1960	3722	9462
10 "LEVEL OF ASSISTANCE"	3768	3057	2854	4815	3036	1325	3264	1770	5345	5330	3370	-352	
11 TREASURY BILLS: AMOUNT OUTSTANDING	3223	4614	6005	7361	8850	9371	9440	10289	10164	10164	10164	10164	

Forecast assumes weekly Treasury bill issues of £800 million (£200 million 2-month bills; £500 million 3-month bills and £100 million 6-month bills) until the end of November and from then on issues to meet the amount of maturing 3-month and 6-month bills only.

TABLE B

MONEY MARKET ASSISTANCE FORECAST 1990/91
(assumes full fund during 1989/90)

SECRET £ millions nsa 20/10/89

	FORECAST Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	TOTAL 1990/91
INFLUENCES ON BANKERS' BALANCES													
1 CGBR (+)	1029	1286	930	-1635	1302	870	-3329	-3510	538	-5679	-1039	2922	-6315
2 CG bank deposits (+)	0	0	0	0	0	0	0	0	300	-300	0	0	0
3 Reserves etc (+)	0	0	0	0	0	0	0	0	0	0	0	0	0
4 Notes & Coin (-)	71	53	-350	166	-269	-183	588	-489	-1402	1801	50	-125	-89
5 National Savings (-)	41	41	41	41	42	42	42	42	42	42	42	42	500
6 CTDs (-)	-8	-8	-8	-8	-8	-8	-8	-8	-9	-9	-9	-9	-100
BGS (-)													
Gross sales (-)	308	308	308	307	307	307	307	307	307	307	307	307	3687
Maturities (+)	0	550	600	956	0	0	1887	500	0	2200	0	0	6693
7 Net sales (-)	308	858	908	1263	307	307	2194	807	307	2507	307	307	10380
8 Other	0	0	0	0	0	0	0	0	0	0	0	0	0
9 TOTAL INFLUENCES ON BANKERS' BALANCES	1441	2230	1521	-173	1374	1028	-513	-3158	-224	-1638	-649	3137	4376
10 "LEVEL OF ASSISTANCE"	-1793	-4023	-5544	-5371	-6745	-7773	-7260	-4102	-3878	-2240	-1591	-4728	
11 TREASURY BILLS: AMOUNT OUTSTANDING	10164	10164	10164	10164	10164	10164	10164	10164	10164	10164	10164	10164	

Forecast assumes weekly Treasury bill issues to meet the amount of maturing 3-month and 6-month bills only.

TABLE C

MONEY MARKET ASSISTANCE FORECAST 1989/90 - INTERVENTION NOT FULLY FUNDED SECRET £ millions nsa 20/10/89

	OUTTURN						FORECAST						TOTAL 1989/90
	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	
INFLUENCES ON BANKERS' BALANCES													
1 CGBR (+)	-362	1291	1085	-1197	1549	15	-2524	-650	-3965	-4174	-122	2125	-6929
2 CG bank deposits (+)	-95	-60	25	17	43	47	0	0	300	-300	0	0	-23
3 Reserves etc (+)	86	-657	-1519	-156	-356	-187	-2000	-26	-65	0	0	0	-4880
4 Notes & Coin (-)	71	53	-350	166	-269	-183	588	-489	-1402	1801	50	-125	-89
5 National Savings (-)	41	70	12	46	269	359	202	211	196	198	198	198	2000
6 CTDs (-)	-84	-8	16	-133	-22	29	-30	0	0	44	44	44	-100
BGS (-)													
Gross sales (-)	875	1203	903	276	512	479	650	356	356	756	356	356	7078
Maturities (+)	825	533	1248	23	1742	1291	806	163	350	1210	954	644	9789
7 Net sales (-)	1700	1736	2151	299	2254	1770	1456	519	706	1966	1310	1000	16867
8 Other	-1312	-147	53	451	-364	335	300	600	300	0	0	0	216
9 TOTAL INFLUENCES ON BANKERS' BALANCES	45	2278	1473	-507	3104	2185	-2008	165	-3930	-465	1480	3242	7062
10 "LEVEL OF ASSISTANCE"	3768	3057	2854	4815	3036	1325	3264	2250	6305	6770	5290	2048	
11 TREASURY BILLS: AMOUNT OUTSTANDING	3223	4614	6005	7361	8850	9371	9440	10289	10164	10164	10164	10164	

Forecast assumes:

£2.4 bn of intervention is not fully funded

Weekly Treasury bill issues of £800 million (£200 million 2-month bills; £500 million 3-month bills and £100 million 6-month bills) until the end of November and from then on issues to meet the amount of maturing 3-month and 6-month bills only.

TABLE D

MONEY MARKET ASSISTANCE FORECAST 1990/91 - INTERVENTION NOT FULLY FUNDED SECRET £ millions nsa 20/10/89

	FORECAST Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	TOTAL 1990/91
INFLUENCES ON BANKERS' BALANCES													
1 CGBR (+)	1029	1286	930	-1635	1302	870	-3329	-3510	538	-5679	-1039	2922	-6315
2 CG bank deposits (+)	0	0	0	0	0	0	0	0	300	-300	0	0	0
3 Reserves etc (+)	0	0	0	0	0	0	0	0	0	0	0	0	0
4 Notes & Coin (-)	71	53	-350	166	-269	-183	588	-489	-1402	1801	50	-125	-89
5 National Savings (-)	41	41	41	41	42	42	42	42	42	42	42	42	500
6 CTDs (-)	-8	-8	-8	-8	-8	-8	-8	-8	-9	-9	-9	-9	-100
BGS (-)													
Gross sales (-)	508	508	508	507	507	507	507	507	507	507	507	507	6087
Maturities (+)	0	550	600	956	0	0	1887	500	0	2200	0	0	6693
7 Net sales (-)	508	1058	1108	1463	507	507	2394	1007	507	2707	507	507	12780
8 Other	0	0	0	0	0	0	0	0	0	0	0	0	0
9 TOTAL INFLUENCES ON BANKERS' BALANCES	1641	2430	1721	27	1574	1228	-313	-2958	-24	-1438	-449	3337	6776
10 "LEVEL OF ASSISTANCE"	407	-2023	-3744	-3771	-5345	-6573	-6260	-3302	-3278	-1840	-1391	-4728	
11 TREASURY BILLS: AMOUNT OUTSTANDING	10164	10164	10164	10164	10164	10164	10164	10164	10164	10164	10164	10164	

Forecast assumes:

£2.4 bn of intervention was not fully funded during 1989/90

Weekly Treasury bill issues to meet the amount of and maturing 3-month and 6-month bills only.

SECRET

GILT-EDGED FUNDING IN NOVEMBER

(Note by Bank of England)

1 This note reviews funding operations in October and considers the prospects for the month ahead.

Market developments in the last month

2 The last month has generally been a difficult one for the gilt market, with the rise in bank base rates to 15%, the fall in sterling and gyrations associated with the sudden fall in equity markets. Yields rose around the end of September and in early October, but fell back as gilts benefited from the fall in equities leaving yields currently broadly where they were at the time of the last funding meeting.

Yields %	19 Oct 87 (peak)	20 April 88 (trough)	19 June 89 (peak)	27 Sept 89 (last funding meeting)	12 Oct 89 (peak)	19 Oct 89
Shorts	10 9/16	8 1/2	11 5/8	11 5/8	11 7/8	11 5/8
Mediums	10 9/16	9 1/8	10 3/4	10 1/2	10 5/8	10 7/16
Longs	10 1/16	9	9 7/8	9 3/4	9 7/8	9 3/4
IGs (2006) (real yield at 5% inflation)	4 11/16	3 3/4	3 5/8	3 5/8	3 13/16	3 3/4
Banks' Base Rates	10	8	14	14	15	15

3 September ended with the market in retreat following worse-than-expected trade figures on 26 September. Conditions were therefore favourable for the successful completion of the fourth reverse auction of gilt-edged stock on 27 September. Table 1 provides brief details of the result of the reverse auction. This was well covered - three times - and secured purchases of £400 mn nominal of stock, which translated into

£458 mn in cash terms since two of the stocks stood well above par. The distribution of offers accepted was narrow, there being only one basis point in yield difference between the average accepted offers and the most unfavourable (to us). The price effect of the reverse auction was about a quarter of a point, which is only about half as large as on the previous occasion that mediums were targeted. In technical terms therefore the auction may be judged a success. This in part reflected unsettled gilt market conditions arising out of uncertainty about UK economic prospects and concerns that interest rates abroad would rise. In more settled circumstances we might have been offered less stock and have had to pay more for it. We skewed purchases towards 13 3/4% Treasury 2000-2003, - accepting 60% of the stock offered to us while taking up less than 10% of the 12% Exchequer 1999-2002 that was offered - because the cheapest offers of 12% Exchequer 1999-2002 and 9% Exchequer 2002 were about an eighth above market levels, whereas 13 3/4% Treasury 2000-2003 was offered on the market. This will have clearly showed that we are sensitive to the prices at which we acquire stock in reverse auctions, and should encourage offers to be closer to the market at any future reverse auction. It might also serve to reduce coverage slightly, though this risk does not seem great.

4 Following the reverse auction, the gilt-edged market softened as sterling eased back ahead of the rise in the Bundesbank's interest rates at the beginning of October, but initially strengthened when UK rates were raised by 1% in tandem with those in Germany on 5 October. With renewed weakness of sterling and the fall below DM 3.00 on 9 October gilts retreated again. They rose very strongly on 16 October, by about a point in the longs, as the upheaval in equity markets encouraged investors to move out of equities and into Government paper. Index-linked, which offer the real returns associated with equities but with less risk, benefited more, initially by about 1 1/2 points.

5 In these market conditions official operations have been directed towards avoidance of excessive market disruption as well as to the achievement of the funding objectives discussed at the last funding meeting. While generally we have been purchasers of stock, on 16 October we sold a small amount at the opening to

avoid market disruption following the sharp fall in equity markets over the weekend. These sales included both conventionals and index-linked stocks. Overall, apart from the auction, we have purchased about £150 million this month, consistent with the agreed guidelines.

6 The Chancellor's comments on funding in his Mansion House speech have been received calmly, with some small decline in prices on account of the implied reduction in the buying in requirement. The principle of the conversion offer has been welcomed by the market, which sees it as a positive step, and the conversion terms also seem right to the market.

Market prospects and funding tactics

7 Market conditions in the month ahead may continue to be unsettled. In part this reflects uncertainties about the response of the economy to the current tightness of monetary policy, the mixed character of recent indicators and the difficulty of interpreting them at this stage in the cycle. It also reflects uncertainties about the volume of funding left to be achieved this year, partly because the market is unclear about the extent to which intervention will be left unsterilised and also because of uncertainty as to what the PSBR will be. With the importance and mobility of foreign gilt holdings, the market will watch exchange rate developments closely, and sentiment would be vulnerable to any softness in the exchange market.

8 The latest funding arithmetic, redefined to exclude Treasury bills, shows a requirement to buy in £940 million a month between November and March. Leaving all this year's intervention, £4,825 million, unsterilised for the time being would mean that we had no further buying-in to undertake in the rest of this year.

9 Against this background, opportunities to purchase stock may arise over the next month. Our reaction presumably should be in accordance with the guidelines agreed at the last funding meeting and in the subsequent discussion with the Chancellor. That is, we would seek to back away from the market to extent that this is consistent with avoiding disruption in the market. On this basis

we might aim to limit our purchases to, say, not more than about £350 million during the month. This may prove not to be possible if the swap banks' reaction to an announcement about Hammersmith and Fulham were to shed a considerable quantity of gilts, risking a discontinuity in the market. In these circumstances, we might need to buy a larger quantity of gilts to manage the market. Since these would mostly be coming from the banks, the direct funding implications of our doing so would be limited.

Bank of England

TABLE 1: SUMMARY OF FOURTH REVERSE AUCTION (29.9.89)

Targetted amount (total) nominal		£400 million	
Stock	12% Exchequer 1999-2002	9% Exchequer 2002	13 3/4% Treasury 2000-2003
Amount issued	£1,600 mn	£1,300 mn	£1,300 mn
Amount in market hands before auction	£1,280 mn	£860 mn	£1,540 mn
Nominal amount of competitive offers	£353.4 mn	£352.6 mn	£510.5 mn
Nominal value of non-competitive offers	£0.1 mn	£0.1 mn	£0.1 mn
Total coverage		3.04 times	
Nominal value of offers accepted	£27.1 mn	£58.6 mn	£314.1 mn
Maximum yield at reverse auction	10.72%	10.14%	10.59%
Average yield at reverse auction	10.71%	10.13%	10.58%
(Non-competitive offers)			
Minimum accepted yield at reverse auction	10.71%	10.12%	10.57%
"Tail": basis points (*)	0	1	1

(*) Difference between average yield and minimum accepted

23/10/89 16:24 BANK OF ENGLAND. NO.002 002

ANNEX: PORTFOLIO PERFORMANCE

1 This annex examines how the portfolio of gilt liabilities has performed over the last three months and over 1989/90 so far. The analysis is the ex post analogue of the usual ex-ante forecasts. The latter ask what the market's future return would be to investing £100 in the different maturity bands on the basis of various assumptions, the former asks what the return in fact turned out to be.

2 Chart 1 shows how yields on representative stocks evolved in the second quarter of the financial year (July-September), while chart 2 illustrates movements in the first quarter (April-June). The market advanced in the first half of the second quarter as evidence accumulated that the economy was responding to tight monetary conditions. Over the summer the economic statistics became less clear cut, and the market retreated. At the very end of the period, yields rose sharply in response to downward pressure on sterling and poor trade figures at the end of September.

3 In the light of the price movements associated with these yield changes, and the dividends that accrued in each maturity range, table A1 shows the rates of return that would have been earned by the market by end-September if £100 had been invested in each band at end-June ie, the cost to the Government of its outstanding debt in each band. The outturn shows an annualised cost to the Government on longs of 6 1/4%, as compared with 7 3/4% for mediums, 6% for shorts and 9 1/2% for ultra shorts.

4 Table A2 shows the corresponding figures for the period end-March to end-September. These figures show that ultra-short gilts have been the costliest to have outstanding, yielding an annualised return of 8%, while longs have been the cheapest to have outstanding (in terms of the buying-in programme longs have turned out to represent the worst buy so far this year).

5 The cost to the Government of any particular portfolio of gilts can be calculated as the weighted average of the cost of the individual components, with the weights representing the share of each maturity band in the total portfolio. Table A3 shows what the portfolio weights were at the beginning and end of the two review periods, and how they compare with the base portfolio weights. Table A4 shows the costs of portfolios with these weights over the three-month period June to September 1989, and table A5 shows the costs during the six-month period April to September 1989.

6 The tables indicate that over both the longer and shorter periods the cheapest funding for the Government would have been achieved if we had stuck to the base portfolio, ie with market holdings in the maturity proportions indicated by that portfolio (10/30/40/20: see first column of Table A3).

7 The base portfolio would have produced a cost of funding of 4.3% over the six months April to September; departing from the portfolio increased the cost of funding to 4.5% (see Table A5). Over the shorter period (three months July to September) Table A4 indicates that we in fact succeeded in reducing somewhat the additional cost of deviating from the base portfolio: we reduced the cost over that quarter from 7.[illegible]% to 7.2%, in part by concentrating purchases away from the longs, which then rose from 11% of the outstanding portfolio to 14%. The outturn cost of 7.2% was nonetheless still higher than the 7.1% that we would have achieved had we stuck to the base portfolio.

Table A1

RETURNS ON INDIVIDUAL BANDS END-JUNE 1989 TO END-SEPTEMBER 1989
(at an annualised rate*)

0-2 years	2-7 years	7-15 years	15+ years
9.6%	6.0%	7.7%	6.3%

Table A2

RETURNS ON INDIVIDUAL BANDS END-MARCH 1989 TO END-SEPTEMBER 1989
(at annualised rate*)

0-2 years	2-7 years	7-15 years	15+ years
8.0%	5.0%	4.0%	1.5%

Table A3

PORTFOLIO PROPORTIONS
(% of conventional gilts in market hands)

	Base portfolio	Actual portfolio as at end-March 1989	Actual portfolio as at end-June 1989	Actual portfolio as at end-September 1989
0-2 years	10	14.1	13.4	11.4
2-7 years	30	28.0	30.6	31.1
7-15 years	40	45.0	44.6	45.7
15+ years	20	12.9	11.5	11.8

Table A4

PORTFOLIO RETURNS (END-JUNE 1989 TO END-SEPTEMBER 1989
(at an annualised rate*)

Base portfolio (10:30:40:20)	Starting perid portfolio (13:31:45:11)	End period portfolio (11:31:46:12)
7.1%	7.3%	7.2%

Table A5

PORTFOLIO RETURNS (END-MARCH 1989 TO END-SEPTEMBER 1989)
(at an annualised rate*)

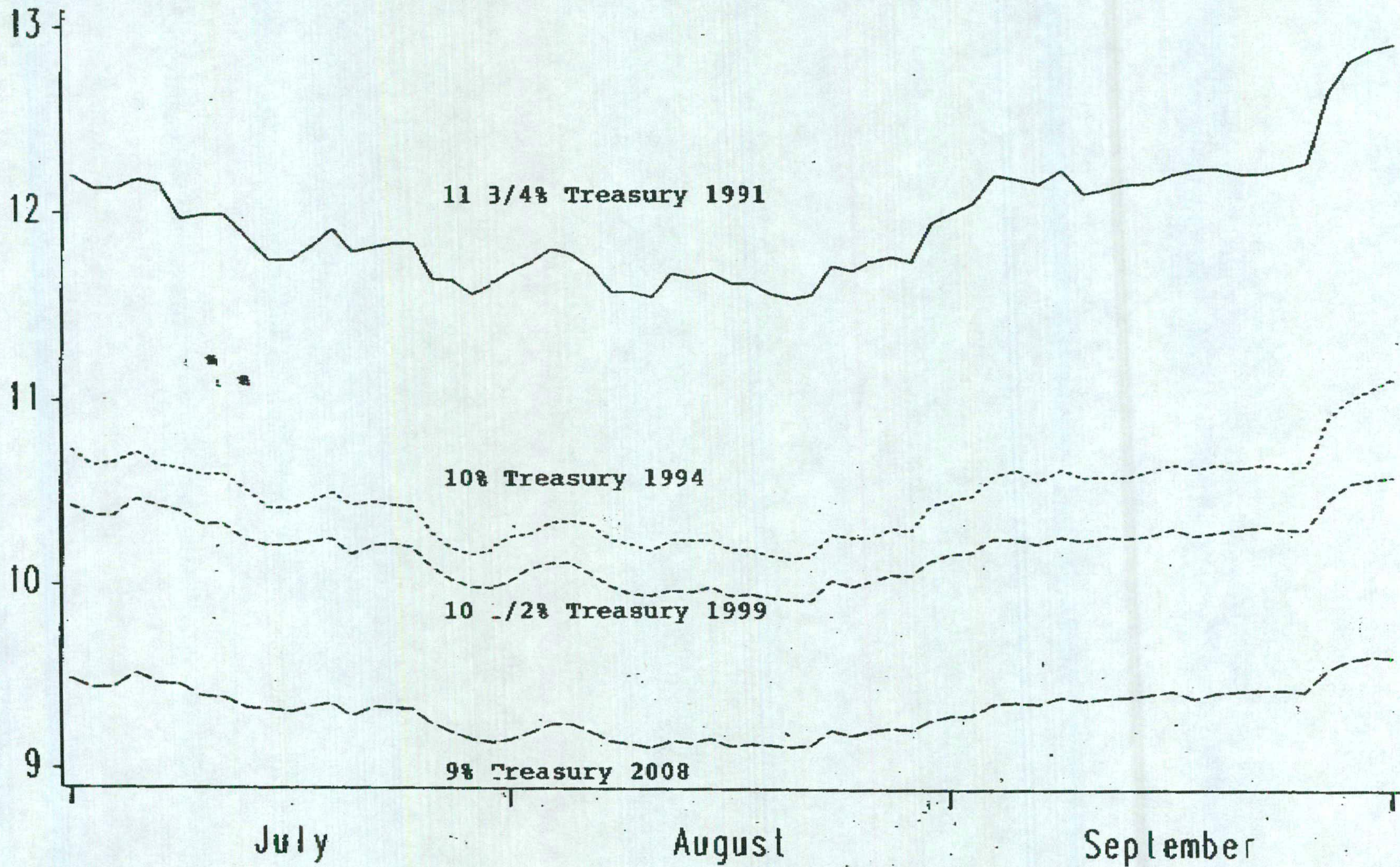
Base portfolio (10:30:40:20)	Starting period portfolio (14:28:45:13)	End period portfolio (11:31:46:12)
4.2%	4.5%	4.5%

*Reflects change in capital values and accruing interest

CHART 1

Yields on British Government Securities

July to September 1989



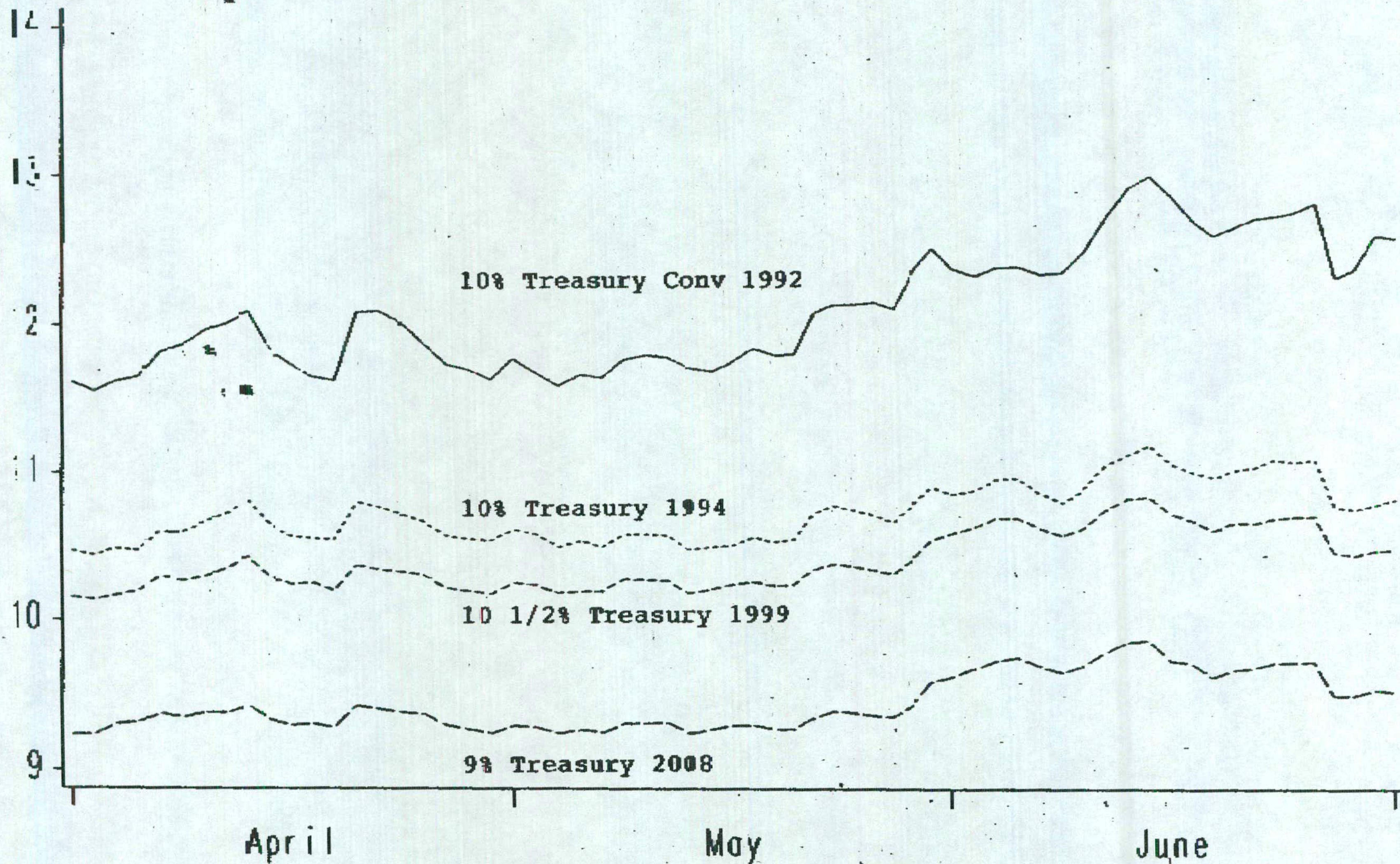
23/10/89 16:27 BANK OF ENGLAND NO.002 011

CHART 2

Yields on British Government Securities

April to August 1989

Per cent



23/10/89 16:28 BANK OF ENGLAND. NO.002 012

mg2.jb/Davies/91g8.19.10

SECRET

GILTS PORTFOLIO MANAGEMENT: OCTOBER FUNDING MEETING

A. Conventional Gilts

The portfolio proportions have altered only slightly since last month. The proportion of ultra-shorts has risen, moving away from the mid-point of their band. Shorts have fallen marginally and now stand at the centre of their range in the base portfolio. The proportion of mediums has risen by almost 1%, despite the reverse auction which accounted for buying-in of £457.7 million of medium dated stock. The proportion of longs has continued to decline towards the bottom end of their range.

Table 1: Distribution of Conventional Gilts

Per Cent

Years	Base Portfolio Ranges	Distribution at 31.3.89	15.9.89	10.10.89	Expected Distribution March 1990*
0-2	5-15	14	12	13	13
2-7	20-40	28	31	30	32
7-15	30-50	45	46	46	44
15+	10-30	13	11	11	11

* Assuming no further buying in

2. This month's note incorporates the Autumn Internal Forecast Scenario for the first time. The yields in the Autumn Internal Scenario reflect the current higher base rates and a steeper inversion of the yield curve than that underlying the June Internal forecast. Yields remain higher than those in the June Internal until 1992 when they are slightly lower and there is a more significant downturn in rates in 1993. Thereafter the forecast returns to the path indicated by the Long Term Planning Assumptions.

Table 2

Forecast Yields   Annual Averages (%)

Autumn Internal	1989	1990	1991	1992	1993
3-month rate	13.9	14.6	12.9	11.4	9.9
20 year rate	9.5	9.6	8.9	8.4	7.8
June Internal					
3-month rate	13.7	13.8	12.8	11.8	-
20 year rate	9.7	9.8	9.3	9.1	-

3. The results shown in Table 3 indicate that under the Autumn Internal Scenario the most expensive stocks to service in the 1 year and under horizon are ultra-shorts. As the horizon lengthens to 5 years, mediums and longs become the most expensive stocks. Table 3 shows the average return expected in each time horizon using the maturity weights of the base portfolio. Thus for example, at the 5 year horizon the return on shorts are 0.6% below average, implying they are cheap to service, whilst mediums are 0.35% above average which shows they are dear to service. Over the 20 year horizon longs are by far the most expensive stocks to service.

4. These results can be compared with those obtained using the MTFS prepared earlier this year. The 6-month forecast yields have been revised upwards slightly to reflect the currently higher yields in the market place but other than this they remain unchanged. Obviously attainment of the 12 month forecast yields is now unlikely making the MTFS forecast less relevant for short horizons. However, changes in yields in the 1 year and under range have only a minor impact on the cost calculations at longer time horizons.

5. The conclusions under the MTFS scenario for horizons of 5 years and over are as follows. Long stocks remain the most

SECRET

Table 3 Cost Advantage by Maturity

Per cent

A. MTFS Scenario

Horizon	6 Mths	12 Mths	5 Yrs	20 Yrs
Average Cost	16.80	17.54	12.16	6.82
Relative Cost*:				
0-2 Years	-2.64	-4.09	-2.52	-1.25
2-7 Years	-4.19	-2.28	-1.66	-0.55
7-15 Years	2.60	1.72	1.02	0.23
15+ Years	2.41	2.04	1.71	1.00

B. Autumn Internal Scenario

Horizon	6 Mths	12 Mths	5 Yrs	20 Yrs
Average Cost	9.76	10.61	11.44	7.81
Relative Cost*:				
0-2 Years	3.15	2.10	0.00	-0.09
2-7 Years	-0.23	-0.59	-0.50	-0.28
7-15 Years	0.30	0.80	0.35	-0.06
15+ Years	-1.83	-1.76	0.13	0.58

C. Constant Inflation Scenario

Horizon	6 Mths	12 Mths	5 Yrs	20 Yrs
Average Cost	14.14	12.56	10.49	10.12
Relative Cost*:				
0-2 Years	0.44	0.69	0.74	0.19
2-7 Years	-0.69	0.09	0.32	0.08
7-15 Years	1.44	1.02	0.23	0.06
15+ Years	-2.07	-2.53	-1.30	-0.32

* + = dear to service: a "good buy"

 - = cheap to service: a "bad buy"

expensive and ultra-shorts the cheapest. However longs are currently at the bottom of their range and therefore a further reduction in their proportion looks to be unwarranted. Medium stocks continue to be relatively expensive to service especially at the 5 year horizon.

6. Finally, the Constant Inflation Scenario looks at the impact on servicing costs of a failure to reduce inflation from present levels. In the 1 year and under horizons mediums are the most expensive stocks to service whilst longs are the cheapest. In the 5 year and over ranges shorts are the most expensive stocks to service whilst longs are the cheapest. Again this serves to outline the importance of the Government's inflation reduction program as the rationale behind the policy of reducing longs and mediums stocks as a proportion of the total portfolio.

7. On balance, the scenarios suggest that when a medium to long term view is taken:

(i) Longs remain the most expensive stocks to service, provided that inflation is reduced from present levels. However they have now moved close to the bottom of their range and therefore a further reduction in their proportion seems unwarranted.

(ii) Medium stocks continue to be relatively expensive to service and their proportion remains well above the mid-point of their range. Thus despite recent buying-in activity in this area there still remains reasons on costs grounds for further purchases.

(iii) Shorts are relatively cheap to service and stand currently at the mid-point of their range. This proportion could be allowed to rise as that of mediums falls.

SECRET

Table 4: Gilts : Gross Sales

£ billion

Conventionals	Ultra Shorts(1)	Shorts	Mediums	Longs	Total
1989-90*	- 0.0	- 1.2	- 2.4	- 1.5	- 5.1
October*	+ 0.0	- 0.0	- 0.6	- 0.1	- 0.7
Index Linked					
1989-90*	0.0	0.1	0.0	+ 0.1	0.2
October*	0.0	- 0.0	- 0.0	+ 0.0	- 0.0

* To 16 October 1989

(1) Ultra short data is for 1 to 2 year gilts only..

B. Indexed Gilts

8. The share in market holdings of indexed gilts in total gilts has risen to 13.9% from 13.7% in September 1989.

9. The break-even inflation rates remain above the inflation rates over each forecast horizon for each scenario. This means that index linked gilts remain attractive on cost grounds.

Table 5: Break-even Inflation Rates

Per Cent

	Break-even Inflation Rate	Average Inflation Rate in Each Scenario		
		MTFS	Autumn Internal	Constant Inflation
a. 5 years	7.5 (7.9)	3.1	3.9	5.0
b. 10 years	6.7 (6.7)	2.6	2.9	5.0
c. 20 years	5.8 (5.8)	2.3	2.5	5.0

C. National Savings

10. Equalising National Savings rates indicate the rates which would need to be paid on Savings Certificates for them to cost the same to the government as conventional gilts. Since the last funding meeting, the rise in gilt yields at the short end has reduced the costs of certificates relative to gilts. Table 6 shows that Fixed Interest Certificates maintain their cost advantage over conventional gilts under all scenarios. Indexed certificates are cheaper than conventionals under the MTFS and Autumn Internal Scenarios; and conventionals only just preserve their real cost advantage under the Constant Inflation Scenario. The cost advantage of conventionals over the Capital Bond has narrowed further.

Table 6: Equalising National Savings Rates

Per Cent

	MTFS	Autumn Internal	Constant Inflation
Rate on Fixed Interest Certificate to match 5 year conventional gilt	8.7	8.8	8.9
Real Rate on Indexed Certificate to match 5 year conventional gilt	5.6	5.0	3.9
Rate on Capital Bond to match 5 year conventional gilt	10.8	10.9	11.1
Current Rates			
Fixed Interest Certificate	7.5		
Indexed Certificate (real rate)	4.0		
Capital Bond	12.0 (11.4)*		

* Estimated cost allowing for early drop out.

11. Table 7 compares the rates on National Savings variable rate products with those on competing products. Since last month, rates on competing products have started to rise due to the increase in base rates. The CTD rates and one-year gilt yields shown in the table are both over three quarters of a per cent up on last month's figures. At the time of compilation bank and building society deposit rates have not yet moved, but some societies have indicated that rates will change on 1st November, by around three quarters of a percent. This will reduce the relative attrativeness of DNS variable rate products.

mg2.jb/Davies/91g8.19.10

SECRET

Table 7: National Savings Instruments: Variable Rate Products

Compound Return	Tax Rate 0	Tax Rate 25	Tax Rate 40	Per cent Administrative costs
Income Bond	12.1	9.0	7.2	0.2
Investment Account	10.8	8.1	6.5	0.4
Premium Bond	6.5	6.5	6.5	1.1
Savings Certificate on GER terms	5.0	5.0	5.0	0.2
12 Month Cost of Government Borrowing (1)	13.3	10.0	8.0	-
CTDs (2)	11.5	8.6	6.9	-
Bank Retail Deposit Rate (3)	8.4	8.4	6.5	N/A
Building Society Retail Deposit Rates:				
-Instant Access (4)	8.2	8.2	6.4	N/A
-90 Days (5)	9.7	9.7	7.6	N/A

(1) Yield on a basket of gilts with maturities clustered around one year.

(2) Rate applies to deposits of less than £100,000.

(3) Average of rates applying to £1,000 investments in selected instant access deposit accounts.

(4) Average of rates applying to £1,000 investments in selected building society instant access accounts.

(5) Average of rates applying to selected 90 day accounts for investments of £10,000

mg2.jb/Davies/91g8.19.10

SECRET

Table A1 Alternative Forecasts of Yields

Per cent

Maturity Band	Horizon				
	Oct 89	6 Mths	12 Mths	5 Yr	20 Yr
A. MTFS					
3-month rate	15.00	14.00	10.6	5.0	3.5
0-2 Years	12.88	12.0	10.0	5.4	4.0
2-7 Years	10.93	10.5	9.30	5.8	4.5
7-15 years	10.55	9.75	9.0	6.2	4.8
15+ Years	9.64	9.0	8.4	6.6	5.0
	Oct 89	6 Mths	12 Mths	5 Yr	20 Yr
B. Autumn Internal					
3-month rate	15.00	15.0	14.6	9.8	6.0
0-2 Years	12.88	12.9	12.6	9.2	5.8
2-7 years	10.93	10.9	10.8	8.4	5.5
7-15 Years	10.55	10.55	10.3	8.25	5.5
15+ Years	9.64	9.6	9.6	8.0	5.4
	Oct 89	6 Mths	12 Mths	5 Yr	20 Yr
C. Constant Inflation					
3-month rate	15.00	13.00	11.3	10.0	10.0
0-2 Years	12.88	11.7	11.1	10.0	10.0
2-7 Years	10.93	10.4	10.10	10.0	10.0
7-15 Years	10.55	10.1	10.0	10.0	10.0
15+ Years	9.64	9.4	9.5	10.0	10.0

mg2.jb/Davies/91g8.19.10

SECRET

Table A2 Final Funds and Rates of Return

£s (Percentage rates of return in brackets)

A. MTFS

	Funding Horizon Six Months	Twelve Months	Five Years	Twenty Years
1 year gilts:	107.06	113.90	160.10	299.90
	(14.16)	(13.45)	(9.64)	(5.57)
5 year gilts:	106.28	115.84	166.81	343.61
	(12.60)	(15.26)	(10.50)	(6.27)
10 year gilts:	109.67	120.18	189.30	399.54
	(19.40)	(19.25)	(13.18)	(7.05)
20 year gilts:	109.58	120.53	195.47	463.80
	(19.21)	(19.57)	(13.86)	(7.82)

B. Autumn Internal

	Funding Horizon Six Months	Twelve Months	Five Years	Twenty Years
1 year gilts:	106.44	113.12	175.00	454.81
	(12.92)	(12.72)	(11.51)	(7.72)
5 year gilts:	104.75	110.28	169.80	438.64
	(9.53)	(10.03)	(10.87)	(7.53)
10 year gilts:	105.02	111.74	177.31	457.32
	(10.07)	(11.41)	(11.79)	(7.75)
20 year gilts:	103.95	109.05	175.50	517.36
	(7.93)	(8.85)	(11.57)	(8.39)

C. Constant Inflation

	Funding Horizon Six Months	Twelve Months	Five Years	Twenty Years
1 year gilts:	107.27	113.68	172.66	746.70
	(14.57)	(13.25)	(11.23)	(10.31)
5 year gilts:	106.70	113.05	169.24	731.43
	(13.45)	(12.65)	(10.80)	(10.20)
10 year gilts:	107.77	114.04	168.54	728.40
	(15.58)	(13.58)	(10.72)	(10.18)
20 year gilts:	106.02	110.27	156.72	677.34
	(12.07)	(10.02)	(9.19)	(9.80)

chex.ps/ds2/88

SECRET

FROM: D I SPARKES
DATE: 24 OCTOBER 1989

PS/ECONOMIC SECRETARY

cc Sir P Middleton
Mr Wicks
Sir T Burns
Mr Scholar
Mr Peretz
Miss O'Mara
Mr Grice
Mr Rich
Mrs Ryding
Mrs Davies
Mrs Chaplin

PWP

FUNDING MEETING

The Chancellor has seen the papers for the funding meeting on 25 October circulated under cover of Ms Ryding's minute of 23 October. He commented that, for the time being, it would be best to go very easy on the buying in.

D.S.

DUNCAN SPARKES

SECRET